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16 **BEFORE THE ARIZONA CORPORATION COMMISSION**

17 IN THE MATTER OF THE
18 APPLICATION OF ARIZONA WATER
19 COMPANY, AN ARIZONA
20 CORPORATION, FOR ADJUSTMENTS
21 TO ITS RATES AND CHARGES FOR
22 UTILITY SERVICE FURNISHED BY
23 ITS WESTERN GROUP AND FOR
24 CERTAIN RELATED APPROVALS.

Docket No. W-01445A-04-0650

25 **ARIZONA WATER COMPANY'S**26 **REPLY BRIEF**

TABLE OF CONTENTS

		Page
1		
2		
3	I. RECOVERY OF CENTRAL ARIZONA PROJECT COSTS	1
4	A. Areas of Disagreement Concerning CAP Cost Recovery	1
5	1. Introduction.....	1
6	2. Under the “Used and Useful” Standard, a Portion of the Casa	
7	Grande Deferred Capital Charge Balance Should Be Included	
8	in Rate Base	2
9	3. A 10-Year Amortization Period Is Appropriate	3
10	4. Staff’s Proposed Conditions 4 and 5 Are Unnecessary and	
11	Inappropriate.....	4
12	B. CAP Cost Recovery Should Not Be Tied to the City’s “Master	
13	Plan.”	6
14	II. RATE BASE	13
15	A. Legal Expenses Relating to Casa Grande’s Condemnation and Other	
16	Litigation.....	13
17	1. RUCO has Misstated the Nature and Source of the	
18	Capitalized Legal Expenses at Issue.....	13
19	2. Arizona Water’s Decisions Were Prudent and Intended to	
20	Benefit Both the Company and Its Ratepayers.....	14
21	3. Arizona Water Should Not Be Penalized Because the City	
22	Saddled Its Citizens With the Cost of Its Illegal	
23	Condemnation Attempt.....	16
24	4. Amortization of Capitalized Legal Fees is a Fair Compromise	17
25	B. The Commission Should Adhere to the Eastern Group Precedent	
26	When Determining the Company’s Cash Working Capital	
	Allowance	17
	III. INCOME STATEMENT	18
	A. The Commission Should Adopt the Annualization of Revenues and	
	Expenses Supported by the Company and Staff.....	18
	B. RUCO’s Adjustment Understates Property Tax Expense	19
	C. RUCO’s Adjustment to Purchased Power Expense Is Understated	20

TABLE OF CONTENTS

(continued)

		Page
	D. Staff's Recommended Adjustment to Rate Case Expense Is Not Based on Any Evidence or Actual Analysis	21
IV.	PURCHASED POWER AND WATER ADJUSTMENT MECHANISMS	22
	A. It Is the Policy of the State and This Commission to Approve Appropriate Adjusters	22
	B. The PPAM and PWAM Are "Appropriate" Adjuster Mechanisms	24
	1. All Applicable Requirements Are Present	24
	2. Fairness Supports Approval of the PPAM and PWAM	25
V.	COST OF CAPITAL	27
	A. Reply to Staff	27
	1. The Methods and Inputs Chosen by Staff Are Conceptually Flawed and Depress the Cost of Equity	27
	2. Staff's Criticisms of the Company's DCF Model Equity Cost Estimates Are Unfounded	29
	a. Staff Has Used "Spot" Prices to Lower the Dividend Yield	29
	b. The FERC's Use of Forward-Looking Growth Rates Is Appropriate	30
	c. Staff's Other Attacks on the FERC 1-Step and 2-Step DCF Models Are Groundless	32
	3. The Risk Premium Method Is Preferable to the CAPM	33
	4. Arizona Water Has Presented Substantial Evidence That It Faces Additional Risk and Therefore Requires a Higher Equity Return	36
	5. Staff's Post-Hearing Leverage Adjustment Should Be Rejected	38
	B. Reply to RUCO	39
	C. Reply to the City	42
VI.	RATE DESIGN	45
	A. Reply to Staff	45

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26

TABLE OF CONTENTS
(continued)

	Page
B. Reply to RUCO	49
C. Reply to the City	50
VII. MISCELLANEOUS ISSUES	52
A. The City's Criticism of Arizona Water's Efforts to Finance Arsenic Treatment Facilities is Unwarranted and Unsupported.	52

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LIST OF PARTIES' PRE-FILED TESTIMONY

Arizona Water Company

Pre-Filed Testimony	Hearing Exhibit	Abbreviation
Direct Testimony of William M. Garfield	A-1	Garfield Dt.
Rebuttal Testimony of William M. Garfield	A-2	Garfield Rb.
Rejoinder Testimony of William M. Garfield	A-3	Garfield Rj.
Direct Testimony of Rick Henderson	A-4	Henderson Dt.
Direct Testimony of Michael J. Whitehead	A-5	Whitehead Dt.
Rebuttal Testimony of Michael J. Whitehead	A-6	Whitehead Rb.
Direct Testimony of Ralph J. Kennedy	A-7	Kennedy Dt.
Rebuttal Testimony of Ralph J. Kennedy	A-8	Kennedy Rb.
Rejoinder Testimony of Ralph J. Kennedy	A-9	Kennedy Rj.
Direct Testimony of Sheryl L. Hubbard	A-10	Hubbard Dt.
Rebuttal Testimony of Sheryl L. Hubbard	A-11	Hubbard Rb.
Rejoinder Testimony of Sheryl L. Hubbard	A-12	Hubbard Rj.

Direct Testimony of Thomas M. Zepp (Corrected version)	A-13	Zepp Dt.
Rebuttal Testimony of Thomas M. Zepp	A-14	Zepp Rb.
Rejoinder Testimony of Thomas M. Zepp	A-15	Zepp Rj.

Utilities Division (Staff)

Pre-Filed Testimony	Hearing Exhibit	Abbreviation
Direct Testimony of Alejandro Ramirez	S-6	Ramirez Dt.
Surrebuttal Testimony of Alejandro Ramirez	S-7	Ramirez Sb.
Direct Testimony of Ronald E. Ludders	S-10	Ludders Dt.
Direct Testimony of Lyndon R. Hammon	S-29	Hammon Dt.
Supplemental Testimony of Steven M. Olea	S-30	Olea Supp.
Surrebuttal Testimony of Ronald E. Ludders	S-32	Ludders Sb.

Residential Utility Consumer Office

Pre-Filed Testimony	Hearing Exhibit	Abbreviation
Direct Testimony of William Rigsby	R-4	Rigsby Dt.
Surrebuttal Testimony of William Rigsby	R-5	Rigsby Sb.

Direct Testimony of Timothy J. Coley	R-28	Coley Dt.
Surrebuttal Testimony of Timothy J. Coley	R-29	Coley Sb.
Direct Testimony of William Rigsby	R-30	Rigsby Dt.
Notice of Errata (to Surrebuttal Testimony of William Rigsby)	R-32	Rigsby Err.

City of Casa Grande

Pre-Filed Testimony	Hearing Exhibit	Abbreviation
Surrebuttal Testimony of Edward F. Harvey	CCG-2	Harvey Sb.
Direct Testimony of Edward F. Harvey	CCG-3	Harvey Dt.

1 In this reply brief, Arizona Water Company ("Arizona Water" or "Company")
2 responds to the arguments made by the Arizona Corporation Commission's Utilities
3 Division Staff ("Staff"), the Residential Utility Consumer Office ("RUCO") and the
4 City of Casa Grande ("City") in their Closing Briefs in this rate proceeding.¹

5 **I. RECOVERY OF CENTRAL ARIZONA PROJECT COSTS.**

6 **A. Areas of Disagreement Concerning CAP Cost Recovery.**

7 **1. Introduction.**

8 There is no dispute that at the end of the test year, Arizona Water's deferred
9 balance of CAP M&I capital charges exceeded \$5 million,² and because the Company
10 must pay M&I capital charges annually regardless of whether CAP water is being used,
11 that balance will continue to increase *unless* the Company is allowed to begin
12 recovering those costs. *E.g.*, Tr. at 1095-1104. With the exception of the City, whose
13 position is discussed in the following subsection, the parties agree that Arizona Water
14 should retain its CAP allocations. *E.g.*, Tr. at 1129-30. Moreover, Staff recognizes that
15 Arizona Water acted prudently in paying M&I capital charges to retain its right to CAP
16 water, rather than surrendering its CAP subcontracts as other municipal providers have
17 done. Tr. at 264-67, 1237-29.

18 Arizona Water is already using CAP water in its Casa Grande system, providing
19 2,279 acre-feet of water (26% of its CAP allocation) for non-potable uses during the test
20 year. Hubbard Rb. at 15. Staff agrees this is an appropriate use of CAP water. Tr. at
21

22 ¹ Citations to the record use the same format and abbreviations as in the Company's
23 Closing Brief. Staff's Closing Brief is abbreviated as "Staff Br.", RUCO's Initial
24 Closing Brief is abbreviated as "RUCO Br.", the City's Closing Brief is abbreviated as
"City Br.", and the Company's Closing Brief is abbreviated as "Company Br."

25 ² The balances of the Company's deferred CAP M&I capital charges as of December
26 31, 2003, were \$3,525,803 for Casa Grande, \$1,046,011 for Coolidge, and \$506,268 for
White Tank. Hubbard Dt. at 12.

1 1109-11. Moreover, Arizona Water is proceeding with a regional water treatment plant
2 near the CAP canal in central Pinal County that will allow treated CAP water to be
3 provided for potable uses in Casa Grande and Coolidge by 2012. Whitehead Rb. at 4-9.
4 Arizona Water is also participating with the Maricopa Water District and Arizona-
5 American Water Company in a regional water treatment plant to be constructed west of
6 Phoenix that will allow treated CAP water to be provided in the White Tank system by
7 2008. Garfield Rb. at 13-14; Tr. at 254-57. Given the Company's actual use of CAP
8 water in Casa Grande, its specific, concrete plans to fully utilize its CAP allocations in
9 the near future, and the lack of any legitimate dispute over the propriety of using CAP
10 water "as soon as possible to help promote the state's goal of getting off the pump" (Tr.
11 at 1129-30 (testimony of Mr. Olea)), there is no reason to delay recovery of CAP-
12 related costs.

13 With the exception of the City, the parties are in general agreement that Arizona
14 Water should be authorized to immediately implement a hook-up fee that would be used
15 to begin recovery of deferred CAP M&I capital charges. See Staff Br. at 6-8; RUCO
16 Br. at 9-10. The primary areas of disagreement are (1) the inclusion of \$142,896 in the
17 Casa Grande system's rate base; (2) the length of the amortization period; and (3) two
18 of Staff's proposed conditions, Conditions 4 and 5. See Company Br. at 11-15.

19 **2. Under the "Used and Useful" Standard, a Portion of the Casa**
20 **Grande Deferred Capital Charge Balance Should Be Included**
21 **in Rate Base.**

22 Staff argues that no deferred CAP M&I capital charges should be included in rate
23 base because Arizona Water's CAP allotments, regardless of whether CAP water is
24 actually provided to customers, "are simply not used and useful." Staff Br. at 6. Staff
25 appears to contend on page 7 of its brief that unless the entire CAP allocation is being
26 used, none of the deferred balance may receive rate base treatment. This is obviously
an extreme position that is unsupported by any authority.

1 There is no dispute that a portion of the Casa Grande CAP allocation was
2 actually used during the test year, thus satisfying the “used and useful” standard. As
3 explained in the Company’s Closing Brief, Reliant Energy reimbursed Arizona Water
4 for a prorata portion of the deferred M&I capital charges. However, Arizona Water has
5 *not* been reimbursed for the deferred M&I capital charge balance related to the
6 remaining CAP water deliveries that occurred during the test year. Company Br. at 11;
7 Garfield Rj. at 9. The prorata portion of the deferred M&I capital charge balance is
8 \$142,896. *Id.* See also Exhibit A-28 (note A). Thus, if Staff’s recommendation were
9 adopted, the Company would be denied the right to earn a return on funds it has
10 invested to retain its CAP allocation directly related to CAP water actually provided to
11 customers during the test year. This would constitute a dramatic departure from normal
12 Commission practice, even putting aside the Commission’s policy, expressed in
13 Decision No. 62993 (Nov. 3, 2000), to allow CAP cost recovery prior to actual CAP
14 water use. See Garfield Rb. at 8-10; Exhibit A-37 (Staff’s CAP cost recovery policy).³

15 **3. A 10-Year Amortization Period Is Appropriate.**

16 Staff is proposing a 20-year amortization period “based on the length of time the
17 M&I subcontracts have been in existence.” Staff Br. at 7. However, Staff’s argument
18 ignores the fact that the deferred balance of M&I capital charges actually accumulated
19 over a 10-year period. The CAP was not completed until 1993, at which time the
20 Central Arizona Water Conservation District (“CAWCD”) issued its notice of
21 completion. Prior to completion of the CAP, subcontractors were required to pay a \$2
22 per acre-foot holding fee, which was credited against future M&I capital charges. The

23
24 ³ RUCO appears to agree with the Company on this issue. RUCO states it opposes the
25 Company’s request, “except as to those Casa Grande customers who are receiving and
26 paying for non-potable CAP water.” RUCO Br. at 9. The Company is only requesting
rate base treatment as to the prorata portion of its deferred capital charge balance related
to CAP water actually provided during the test year.

1 obligation to pay annual M&I capital charges did not arise until 1994, and, as Mr.
2 Garfield explained, those charges turned out to be substantially greater than anticipated.
3 Garfield Rb. at 6-7; Tr. at 264-266. *See also* Tr. at 1095-97 (testimony of Mr. Olea).

4 Because the test year balance of deferred M&I capital charges at December 31,
5 2003, is the result of payments made to CAWCD after 1993, a 10-year amortization
6 period is appropriate. *E.g., Arizona Water Co.*, Decision No. 66849 (March 19, 2004)
7 (Eastern Group) at 10. In that decision, the Commission found that it is appropriate to
8 allow amortization over the same period in which costs were incurred. The
9 Commission should do so again in this case.⁴

10 **4. Staff's Proposed Conditions 4 and 5 Are Unnecessary and**
11 **Inappropriate.**

12 The Company has no objection to preparing and providing Staff a CAP Water
13 Use Plan ("CAPWUP") by December 31, 2006, or six months prior to the Company's
14 submission of its next general rate application, whichever occurs first. Further, the
15 Company will accept the bulk of Staff's conditions, including Condition 2 (as clarified
16 by Mr. Olea), which provides that the Company "must make best faith efforts to include
17 the cities of Casa Grande and Coolidge in the development of the CAPWUP." *See*
18 *Company Br.* at 12-13.

19 Condition 4, however, may create a conflict with Commission orders issued in
20 the Northern and Eastern Group cases, which require Arizona Water to file general rate
21 applications for those systems by September 30, 2007, based on a 2006 test year.
22 Decision No. 66849 at 31 and 41; Decision No. 66400 at 6-10 and 23. Those
23 applications will reflect the Company's investment in, and increased operating expenses
24

25 ⁴ Again, RUCO agrees with the Company's recommendation as to the portion of the
26 Casa Grande CAP allocation actually used during the test year. *RUCO Br.* at 9.

1 associated with, arsenic treatment facilities. *Id.* Assuming an arsenic cost recovery
2 mechanism is approved in this case (and the Company's request is unopposed), the
3 same requirement would be imposed with respect to the Western Group systems. Given
4 the magnitude of costs related to arsenic treatment, which is undisputed (*e.g.*, Garfield
5 Dt. at 6-9; Kennedy Dt. at 10-16), those rate applications will be critical to ensure the
6 Company's financial viability.

7 Unfortunately, under Condition 4, the CAPWUP must not only be submitted by
8 the Company, but also approved by the Staff. If the CAPWUP is not approved, the
9 Company would be prohibited from filing the required Company-wide general rate
10 application. However, there is no deadline for Staff action on the CAPWUP. To avoid
11 a future conflict, the Commission should either eliminate the requirement that Staff
12 approve the CAPWUP or, at a minimum, *not* make Staff's approval a sufficiency
13 requirement under A.A.C. R14-2-103.

14 Under Condition 5, if the Commission does not approve the CAPWUP, the hook-
15 up fee would terminate and, in addition, all hook-up fees collected to that point must be
16 refunded with interest. As explained in the Company's Closing Brief, this refund
17 requirement is unnecessary. Company Br. at 14-15. The Company clearly has a strong
18 incentive to prepare and submit an acceptable CAPWUP if the CAP hook-up fee would
19 be subject to immediate discontinuance. Moreover, Mr. Olea was unable to explain
20 what would happen if the Company was required to refund CAP hook-up fees, *i.e.*,
21 would those fees be added back into the deferred CAP M&I capital charge balance or,
22 as Mr. Olea stated, come "out of the shareholders' pockets." Tr. at 1204.

23 The Company would already be required to prepare and submit a CAPWUP that
24 is acceptable to Staff under Condition 4. If the Company complies with Condition 4,
25 and Staff accepts the Company's CAPWUP, it would be unfair and punitive to
26 subsequently require the Company to refund all hook-up fees collected to that point

1 (with interest) if the Commission were to disagree with some aspect of that plan and not
2 approve it.

3 **B. CAP Cost Recovery Should Not Be Tied to the City's "Master Plan."**

4 The City spends nearly half of its 30 page brief arguing that the Company should
5 be ordered by the Commission to develop, "in partnership with the City of Casa
6 Grande," a "water resource master plan" for the *entire* Western Group and that the
7 recovery of CAP costs should be conditioned on the preparation of such a plan. City Br.
8 at 10-11. The process demanded by the City would be "open and inclusive," and
9 involve an "open planning process" controlled by the City. *Id.* at 11. "The City should
10 be afforded the opportunity to participate in all stages of the planning process, including
11 the earliest tasks relating to what information will be included in the water resources
12 master plan and who will be responsible for designing and drafting the plan." *Id.*

13 This is an extraordinary and unprecedented request. In effect, the City asks the
14 Commission to force Arizona Water to cede control of fundamental management
15 decisions to a municipality that in the past has tried to condemn its water system and has
16 threatened to do so again. This is contrary to Arizona law. *Southern Pacific Co. v. Ariz.*
17 *Corp. Comm'n*, 98 Ariz. 339, 343, 404 P.2d 692, 694-95 (1965) ("it cannot be doubted
18 but that a public utility may, *in the first instance*, in the exercise of its managerial
19 functions, determine the type and extent of service to the public within the limits of
20 adequacy and reasonableness") (emphasis in original). Moreover, it conflicts with
21 recently enacted legislation that requires all community water systems to submit water
22 system plans to the Department of Water Resources. *See* A.R.S. § 45-330, *et seq.*
23 (community water system planning and reporting requirements).

24 As a preliminary matter, it is important to consider the context in which this
25 extraordinary request has arisen. The Company has incurred more than \$5 million in
26 costs to retain its CAP allocations for its Casa Grande, Coolidge and White Tank

1 systems, and requested authority to begin recovering those costs. *E.g.*, Hubbard Dt. at
2 12-17. The Commission has previously approved recovery of deferred CAP costs in the
3 Company's Eastern Group case, and has authorized other water utilities to recover their
4 deferred CAP costs prior to actually using CAP water, including the Agua Fria, Sun
5 City and Sun City West water systems operated by Arizona-American Water Company.
6 *Id.* at 13. Further, based on the work done by the Commission's Water Task Force (in
7 which Arizona Water was an active participant), the Commission has recognized the
8 importance of CAP water as a long-term supply and the need to allow water utilities to
9 begin to recover CAP-related costs prior to CAP water use. Decision No. 62993 (Nov.
10 3, 2000) at 9-10 (attached to Mr. Garfield's Rebuttal Testimony). It directed Staff to
11 develop a detailed statement of policy on CAP cost recovery. A proposed CAP cost
12 recovery policy was in fact developed, and is posted on the Commission's official
13 internet site. Garfield Rb. at 9 and Exhibit WMG-2.

14 Thus, the Company reasonably anticipated that a CAP cost recovery mechanism
15 would be authorized for the Casa Grande, Coolidge and White Tank systems. Although
16 Staff initially opposed recovery of any CAP-related costs (even in Casa Grande, where
17 CAP water is being used), the Company and Staff are now largely in agreement on the
18 mechanism and terms of the CAPWUP proposed in Mr. Olea's Supplemental
19 Testimony, as previously discussed.

20 Mr. Olea, Staff's primary witness on CAP cost recovery, testified that the
21 additional information demanded by the City is not needed for Staff to evaluate the
22 Company's plan to utilize its CAP allocations. Tr. at 1201-02. Moreover, earlier this
23 year, the Legislature amended Title 45 to require all community water systems to
24 prepare a water system plan and to submit such plan to the Director of the Department
25 of Water Resources for review and approval. 2005 Ariz. Legis. Serv. Ch. 223 (West)
26 (copy attached as Reply Exhibit 1). All of Arizona Water's systems, including Casa

1 Grande, must submit a water plan. A.R.S. § 45-331.⁵ Among other things, the plan
2 must generally “evaluate the water supply needs in the service area and propose a
3 strategy to meet identified needs,” and contain other information specified in A.R.S.
4 § 45-331(H). The Director is required to “prepare a guidance document to assist
5 community water systems in preparing the water system plan,” and must cooperate with
6 the operators of community water systems (including private water companies) in
7 developing the guidance document. A.R.S. § 45-331(M). This new requirement,
8 combined with Staff’s recommended CAPWUP, should eliminate any concerns that the
9 City may have regarding water resources planning.

10 Unfortunately, the City has seized on the issue of CAP cost recovery as an
11 excuse to “leverage” (to use the City’s term) Arizona Water into preparing a water
12 resource master plan that would contain substantially more information than Staff’s
13 CAPWUP, including historical information dating back to 1990 and information that
14 has nothing to do with CAP water use. *Compare* Exhibit CCG-7 with Olea Supp.,
15 Schedule SMO-4. To support this extraordinary demand, the City presented one
16 witness, Edward Harvey, a natural resources economist from Denver, Colorado. Mr.
17 Harvey has no prior experience with Commission ratemaking proceedings. Tr. at 846-
18 47. More importantly, he made no effort to understand Arizona Water’s Casa Grande
19 system. Mr. Harvey did not tour the facilities, did not speak with any Company
20 personnel, did not speak with representatives from the Commission’s Engineering Staff
21
22

23 ⁵ Large community water systems (defined as systems serving more than 1,800
24 persons), must submit a water plan by January 1, 2007. A.R.S. §§ 45-330 and 45-
25 331(B). The Casa Grande and Coolidge systems serve more than 1,850 persons, and
26 therefore water plans must be submitted for those systems by that date. The remaining
Western Group systems are small community water systems, and water plans for small
community water systems must be submitted by January 1, 2008.

1 and did not speak with any customer of the Company. *Id.* at 853-57.⁶ Due to his lack
2 of knowledge, Mr. Harvey's testimony is extremely vague and general, and largely
3 consists of unfounded assertions. *See, e.g.,* Harvey Dt. at 4; Harvey Sb. at 2-3.

4 Noticeably absent from Mr. Harvey's testimony is any evidence showing a
5 legitimate need for a water resource master plan. For example, there is no evidence that
6 Arizona Water has not adequately planned for water resources, that Arizona Water has
7 violated any state law or regulation, or that Arizona Water has been unable to meet
8 water demands by new customers in Casa Grande. In fact, there is no evidence that
9 Arizona Water has experienced any sort of difficulty providing reliable water service at
10 a reasonable cost in Casa Grande or in any of its 17 other water systems. Arizona Water
11 is one of the largest, most sophisticated and best managed water providers in Arizona,
12 and there is nothing in the record suggesting otherwise.

13 To make up for this lack of evidence, the City has attached to its brief an article
14 from a local Casa Grande newspaper, claiming the article "is further evidence of the
15 pressing need to predict future demand and to begin planning for that demand." City
16 Br. at 8. The statements in the newspaper article are, of course, hearsay and would not
17 be admissible during a hearing absent a proper foundation. The City, however, asks the
18 Commission to take judicial notice of the newspaper article anyway. *Id.* at n. 2.
19 However, the statements appearing in the article are not subject to judicial notice. "A
20 fact of which a court may take judicial notice must be so notoriously true as to not be
21 subject to reasonable dispute, so that evidence may not be received to dispute it." *State*
22 *v. Lynch*, 115 Ariz. 19, 22, 562 P.2d 1386, 1389 (App. 1977), *following Phelps Dodge*
23
24

25 ⁶ In fact, Mr. Harvey admitted the City did not speak with any customers about Arizona
26 Water's utility service.

1 *Corp. v. Ford*, 68 Ariz. 190, 196, 203 P.2d 633, 639 (1949).⁷ See also *Vigue v. Noyes*,
2 113 Ariz. 237, 240, 550 P.2d 234, 238 (1976).⁸ No other evidence has been presented
3 by the City to support its extraordinary demand.

4 As discussed in the Company's Closing Brief, the City's demands in this case are
5 rooted in its unlawful attempt to condemn Arizona Water's Casa Grande system. See
6 *City of Casa Grande v. Arizona Water Co.*, 199 Ariz. 547, 20 P.2d 590 (App. 2001);
7 Exhibit R-6 (Superior Court Order dismissing condemnation action). While the City's
8 condemnation action was pending, the City Attorney wrote a letter to Arizona Water, in
9 which the City threatened to continue to prosecute its condemnation (and, if necessary,
10 to initiate another condemnation action in the future) and to intervene in various
11 proceedings involving Arizona Water, including applications before the Commission.
12 Exhibit A-22. The letter also proposed a "settlement," under which Arizona Water's
13 CAP allocation for its Casa Grande system would be transferred to the City or to a water
14 provider designated by the City. *Id.* Mr. Garfield explained that the Company "looked
15 at this as a very serious threat . . . , not just concerning the [condemnation] litigation that
16 was ongoing at the time, but in all future arenas where we might find ourselves, such as
17 the Commission, such as Department of Water Resources." Tr. at 493.

18 As the record shows, the City followed through with its threats. For example, the
19 City filed an amicus brief in the lawsuit filed by Arizona Water challenging the manner
20

21 ⁷ Notably, in *Phelps Dodge*, which involved an appeal of an Industrial Commission
22 decision, the court held that state agencies acting in a judicial or quasi-judicial capacity
23 are subject to the same limitations as courts of record in judicially noticing facts. 68
Ariz. at 198, 203 P.2d at 639.

24 ⁸ If the Administrative Law Judge is nevertheless inclined to consider the statements
25 appearing in the newspaper article, the Company has attached an Affidavit from Mr.
26 Garfield, Reply Brief Exhibit 2, containing a detailed discussion of the events
referenced in the article and explaining why the City's reliance on the article is
misplaced.

1 in which the Department of Water Resources regulates municipal providers under
2 Second Management Plan, opposing the Company. Tr. at 491-92. In support of its
3 participation in the litigation (which involved the Company's Apache Junction system),
4 the City argued that Arizona Water was violating state policy by not using its CAP
5 allocation to serve Casa Grande residents:

6 During the pendency of this appeal, Arizona Water is
7 negotiating with a private corporation to provide CAP water
8 and/or groundwater to an electrical generation plant that
9 requires over 3 million gallons of water per day on an average
10 annual basis. . . . Unlike other municipal providers having
11 CAP allocations, Arizona Water is not providing any of its
CAP allocation to Casa Grande residents. Faced with a
seriously overdrafted aquifer, the City's future depends on the
policies of the Groundwater Management Act and the
regulations of the Department being followed by Arizona
Water.

12 City of Casa Grande's Motion for Leave to File Amicus Brief, at 2, *Arizona Water Co.*
13 *v. Ariz. Dept. of Water Resources* (Maricopa County. Super. Ct. Nos. CV 90-01840 and
14 CV 99-08015 consolidated) (copy attached as Reply Brief Exhibit 3).

15 The City also has intervened in a number of different proceedings before the
16 Commission involving Arizona Water. The City intervened in both the Northern Group
17 and the Eastern Group rate cases, even though the Casa Grande system is part of the
18 Company's Western Group. *See* Decision No. 66400; Decision No. 66849; Tr. at 480-
19 81. The City also intervened in applications filed by the Company to extend the Casa
20 Grande system's certificated area. Tr. at 490-91. The City also filed a complaint
21 against Arizona Water at the Commission, in which the City objected to the Company
22 serving CAP water to Reliant Energy's power plant. Tr. at 499. At the same time, the
23 City delayed acting on the Company's application to renew its franchise, while
24 approving franchises for other utilities. Tr. at 494 and 520.

25 In addition, despite the dismissal of its condemnation action, the City maintains a
26 "Water Service Area Map" on its official internet site, containing approximately 260

1 sections (i.e., square miles) of land, including a substantial portion of Arizona Water's
2 certificated area, as well as the certificated areas of several small water utilities. Tr. at
3 531-32; Exhibit A-24. The Casa Grande City Council passed a resolution adopting this
4 map. *Id.* at 532-34. The City has also caused problems for developers in areas adjacent
5 to the Company's certificated area. Tr. at 495-96 and 532-34.

6 When viewed against this backdrop, the City's alleged concerns about Arizona
7 Water's on-going ability to provide water service (which are unsupported by any
8 competent evidence) and its demand that Arizona Water be ordered to prepare a water
9 resource master plan, "in partnership" with the City, to obtain recovery of CAP-related
10 costs are simply disingenuous. The City is the only party to this proceeding questioning
11 the use of CAP water. Mr. Harvey testified that "[w]e have no proof that CAP is really
12 needed, by what date and by whom." Harvey Sb. at 2. Similarly, in its brief, the City
13 argues that Arizona Water "cannot know" whether CAP water use is appropriate unless
14 a water resource master plan is prepared.⁹ If there is "no proof" that CAP water is
15 "really needed," as the City now contends, why did the City emphasize the Company's
16 non-use of CAP water in its motion for leave to file its amicus brief in the Company's
17 appeal of the Second Management Plan's conservation requirements? And why did the
18 City specifically demand the transfer of the Company's CAP allocation in its
19 "settlement" letter?

20 The bottom line is that given the City's actions during the past five years, the
21 City must be viewed as a competitor of Arizona Water. It is telling that the City's only
22 witness is a natural resources valuation expert, who has already assisted the City in

23
24 ⁹ Mr. Whitehead, the Company's Vice President of Engineering, testified that CAP
25 water is the least-cost, renewable source of water. Tr. at 552-53. The City has
26 presented no evidence to the contrary, and simply argues this fact cannot be known
without a plan, the preparation of which would be controlled by the City. This
exemplifies the level of the City's analysis in this case.

1 acquiring a small water utility. Harvey Dt. at 1; Tr. at 863-64 and 891. The information
2 that would be required by the City's recommended water resource master plan, which
3 the City would control (City Br. at 11), could be used against the Company in the City's
4 next condemnation action. Tr. at 495 and 517-18. The City has *not* represented to the
5 Commission that the information won't be used for that purpose. In fact, Mr. Harvey
6 made a point of emphasizing that he cannot "commit" the City to anything. Tr. at 848.

7 In short, given the City's relationship with Arizona Water, the lack of any
8 legitimate evidence supporting the need for the City to be a "partner" in the
9 development of a water resource master plan, the City's attempt to condemn Arizona
10 Water and related threats, Mr. Olea's testimony that the Staff's CAPWUP is adequate to
11 verify that the Company's CAP allocation will be used, and the new law requiring
12 community water system planning and reporting, there is no basis to grant the City's
13 extraordinary request.

14 **II. RATE BASE.**

15 **A. Legal Expenses Relating to Casa Grande's Condemnation and Other** 16 **Litigation.**

17 **1. RUCO has Misstated the Nature and Source of the Capitalized** 18 **Legal Expenses at Issue.**

19 As discussed in its brief, Arizona Water seeks authority to include \$767,454 of
20 capitalized legal expenses in rate base. Exhibit A-21. These expenses arise from four
21 separate legal proceedings relating to the Company's Certificate of Convenience and
22 Necessity ("CC&N") and exclusive right to furnish utility service: (1) the Company's
23 defense of the City's condemnation action (\$314,353); (2) the Company's defense of
24 the City's complaint at the Commission (\$34,301); (3) an action against the City in
25 federal court (\$155,061); and (4) an action against the City in state court (\$263,739).
26 *Id.* The condemnation action was unrelated to the other three proceedings, all of which
involved a dispute over the City's sale of effluent to the Company's customers. Tr. at

1 300.

2 In its brief, however, RUCO claims that all of the Company's legal expenses
3 were incurred "attempting to get a favorable resolution to an issue [whether effluent is
4 groundwater or surface water] that had already been decided by the Arizona Court of
5 Appeals in 1991." RUCO Br. at 3. Similarly, RUCO asserts that all of the legal
6 expenses were incurred in disputes involving the City's right to sell effluent within the
7 Company's service territory. *Id.* In fact, in several places, RUCO ties the City's
8 condemnation directly to the dispute over the City's competing effluent sales. *E.g.*,
9 RUCO Br. at 4, 5 and 7 (recovery of all legal expenses, including those incurred in the
10 condemnation action, should be denied because it was clear that Arizona law does not
11 consider effluent to be groundwater or surface water).

12 RUCO's attempt to tie the City's condemnation action into the dispute over the
13 City's effluent sales is groundless. No other party (including the City) has suggested
14 that the condemnation action, initiated by the City in an effort to acquire a portion of the
15 Company's Casa Grande CC&N and system, as well as the Company's CAP allocation,
16 was in any way tied to the dispute over the City's competing effluent sales. Nor is
17 Arizona Water aware of any evidence linking the two disputes. In fact, when RUCO
18 attempted to establish such a link during the hearing, the evidence reflected that
19 "effluent" was neither the reason for, nor an issue in, the City's unlawful condemnation.
20 Tr. at 300. Thus, the dispute over the City's competing effluent sales and the
21 Company's defense of the City's unlawful condemnation action were separate and
22 unrelated, and must be separately evaluated and not scrambled together as RUCO has
23 done in its brief.

24 **2. Arizona Water's Decisions Were Prudent and Intended to**
25 **Benefit Both the Company and Its Ratepayers.**

26 Boiled down, opposition to inclusion of the capitalized legal expenses in rate

1 base centers on whether ratepayers benefited from those expenditures. Staff argues that
2 the legal expenses were "imprudent" because they benefited shareholders, not
3 ratepayers. *See* Staff Br. at 8. RUCO also accuses the Company of exercising "poor
4 judgment" by incurring legal expenses in a "reckless," "unnecessary," "unreasonable"
5 and "overzealous" pursuit of litigation. RUCO Br. at 3, 7-8. The City asserts in several
6 places that the litigation fees were incurred in "highly questionable" litigation intended
7 to "enrich" the shareholder (which is rather ironic given that the City was found by two
8 courts to have violated Arizona law in unsuccessful condemnation action). City Br. at
9 17, 21. However, not every expense that is recoverable in rates results in a direct
10 benefit to ratepayers. Arizona Water operates a business, and it is certainly entitled to
11 protect its rights in the face of a condemnation action or other interference by a
12 governmental entity. To argue otherwise suggests that a utility has no recourse when
13 threatened with unlawful conduct that would interfere with its exclusive right to furnish
14 utility service.

15 In this case, moreover, there is substantial evidence that the Company's decisions
16 were prudent when made and intended to benefit both the Company and its ratepayers.
17 For example, in challenging the City's competing effluent sales, the Company sought to
18 maximize the use of its CAP allocation, in addition to expanding the customer base over
19 which the burden of cost recovery would be spread. With respect to the City's unlawful
20 condemnation action, the Company has shown that its customers were threatened by the
21 City's action. Garfield Rb. at 22; Garfield Rj. at 3-4; Tr. at 419-20, 427-30. The City
22 was acting against the expressed intention of its citizenry. The City was also attempting
23 to "cherry pick" Arizona Water's assets and customers, as well as take the Company's
24 CAP allocation for its own use. The facilities that would have been left behind would
25 have been isolated and insufficient to properly serve the remaining customers, forcing
26 the Company and its ratepayers to bear the cost of major upgrades. *Id.* *See also* Tr. at

1 419-420.

2 In response, the other parties assert that that harm cited by the Company was
3 merely potential. For instance, regarding the City's unlawful condemnation, they argue
4 that because no decision on the merits was reached, it cannot be known whether
5 customers are better or worse off. *See* Staff Br. at 10-11; City Br. at 19-20. This
6 argument ignores the crucial fact that Arizona Water had to make a decision whether to
7 defend the condemnation when the City brought it, not after the action was over and its
8 impacts known. At that time, Arizona Water reasonably believed the City's action
9 threatened its ability to adequately and reliably serve *all* of its customers in the Casa
10 Grande area at reasonable rates. *E.g.*, Garfield Rb. at 22. Moreover, this argument
11 ignores the evidence presented by the Company, which is in the best position to know
12 how the condemnation would have impacted its future operations and its remaining
13 customers, had the City's unlawful action not been challenged. Garfield Rb. at 21-24;
14 Garfield Rj. at 3-7.

15 **3. Arizona Water Should Not Be Penalized Because the City**
16 **Saddled Its Citizens With the Cost of Its Illegal Condemnation**
Attempt.

17 It has also been suggested that recovery of the capitalized legal expenses should
18 be denied because the citizens of Casa Grande had to pay the City's costs. Casa Grande
19 Br. at 22. This argument is a red herring. The citizens of Casa Grande elected the
20 Mayor and City Council, authorizing those officials to act of their behalf and spend
21 taxpayer funds. Those officials decided to initiate a condemnation action without fully
22 complying with Arizona law, and the condemnation was dismissed. The City then
23 elected to appeal, and the Court of Appeals upheld the dismissal. As a direct result of
24 the City's actions, Arizona Water was required to expend funds to defend its rights
25 under its CC&N.

26 Admittedly, Casa Grande residents financed the unlawful condemnation action

1 (although there was no evidence presented regarding how much this cost and how it was
2 actually financed). However, this unfortunate circumstance does not mean that Arizona
3 Water should be forced to bear the brunt of the City's unlawful actions. Ultimately, if
4 City residents are unhappy with the decisions of their elected officials, they can remove
5 those officials from office. Tr. at 937. Arizona Water, on the other hand, has no means
6 of recovering its legal expenses except through its rates and charges for service. The
7 Company should not be denied recovery of legitimate expenses caused by City officials'
8 ill-advised use of taxpayer funds.

9 **4. Amortization of Capitalized Legal Fees is a Fair Compromise.**

10 Finally, RUCO and Casa Grande argue that rate base treatment for the
11 capitalized legal expenses should be denied because the proposed treatment -- inclusion
12 in Plant Account 303 -- would lead to a perpetual recovery. RUCO Br. at 9; Casa
13 Grande Br. at 16. This is an extremely draconian remedy, particularly given the fact
14 that neither party suggests an alternative method of recovery.

15 As suggested by the Company in its brief, the Commission could include the
16 capitalized expenses in rate base subject to amortization over an appropriate number of
17 years. Company Br. at 20, *citing* Tr. at 574, 587. Staff apparently would accept that
18 approach. Staff Br. at 8. Consequently, if the Commission concludes that recovery
19 subject to an amortization is a fair compromise between the interests of the Company
20 and its customers, the Company would not object. This would be far more equitable
21 than simply denying recovery of prudently incurred costs.

22 **B. The Commission Should Adhere to the Eastern Group Precedent**
23 **When Determining the Company's Cash Working Capital Allowance.**

24 Staff and RUCO agree that the Company's method to determine its cash working
25 capital allowance is consistent with the Commission's decisions in both the Northern
26 and Eastern Group rate cases. Staff Br. at 11; RUCO Br. at 11. Nevertheless, both

1 parties now seek a different set of lead/lag factors for state and federal income taxes. In
2 support of their arguments, Staff and RUCO rely on lead/lag factors from other Arizona
3 utilities introduced by RUCO. Staff Br. at 12; RUCO Br. at 11. *See also* Coley Sb. at
4 4. Both parties suggest that because the assessment and payment of income taxes is
5 controlled by federal and state law, the lead/lag factors should also be controlled by
6 federal and state law, and therefore be the same.

7 As Ms. Hubbard testified, however, the determination of lead/lag factors is
8 specific to each utility. Tr. at 811. In fact, each of the utilities introduced by RUCO
9 had *different* lead/lag factors for state and federal income taxes, including some very
10 substantial differences, showing that while all utilities pay taxes, the particular internal
11 accounting method differs from utility to utility. *Id.* During the hearing, the witness
12 for RUCO grudgingly acknowledged this fact. Tr. at 990. The Commission has twice
13 in the last five years determined that the lead/lag factors for state and federal income
14 taxes used by the Company are appropriate. *See* RUCO Br. at 11. There is no reason to
15 ignore those decisions.

16 **III. INCOME STATEMENT.**

17 **A. The Commission Should Adopt the Annualization of Revenues and** 18 **Expenses Supported by the Company and Staff.**

19 As discussed in the Company's Brief, the Company annualized test year
20 revenues and expenses consistent with the methodology approved in the Eastern Group
21 decision. Company Br. at 22, *citing* Decision No. 66849. Under this methodology, the
22 Company compared the year-end number of customers to the number of customers at
23 the beginning of the test year to calculate an average number of customers during the
24 test year. Tr at 760. Staff adopted the Company's revenue and expense annualization.
25 Tr. at 1238-39. Staff witness Carlson explained on cross-examination that the
26 methodology used is commonly employed by water utilities and one of several proper

1 annualization methods. Tr. at 1318-20. The fact that RUCO might believe that its
2 methodology is better is insufficient basis for the Commission to deviate from the
3 methodology approved for the Company in prior rate decisions. This is especially true
4 in light of the other flaws in RUCO's annualization, none of which is addressed in
5 RUCO's brief. See Company Br. at 22 (discussing RUCO's use of all customer classes
6 contrary to prior decision and RUCO's flawed regression analysis).

7 **B. RUCO's Adjustment Understates Property Tax Expense.**

8 RUCO has advanced the same methodology for determining property tax
9 expense in seven other rate cases. Exhibit A-31. See also *E.g., Rio Rico Utilities*,
10 Decision No. 67279 at 8; *Arizona Water Co.*, Decision No. 64282 at 12-13; *Bella Vista*
11 *Water Co.*, Decision No. 65350 (Nov. 1, 2002) at 16; *Arizona-American Water Co.*,
12 Decision No. 67093 (June 30, 2004) at 9-10. RUCO's methodology has already been
13 rejected five times. *Id.*¹⁰ RUCO does not present anything new or different in this case
14 with respect to the determination of property tax expense levels, but again contends that
15 only RUCO understands and correctly applies the ADOR formula used to calculate a
16 utility's full cash value.

17 First, RUCO is *not* the only party using the ADOR formula to determine an
18 appropriate level of property tax expense. In fact, all of the parties use the same ADOR
19 formula; RUCO just uses different inputs from Staff and the Company. Tr. at 1002-03;
20 Hubbard Rj. at 10. The Company and Staff included one year of projected revenues to
21 ensure that the Company will not under recover property tax expense. Hubbard Rb. at
22 25; Hubbard Rj. at 10. Property taxes will increase when new rates go into effect, and
23 the amount of that increase is known and measurable. *Id.*

24 _____
25 ¹⁰ No decision on property taxes was rendered in the other two proceedings and a
26 decision is still pending in the Chaparral City rate case (Docket No. W-02113A-04-
0616). Exhibit A-31.

1 RUCO also asserts that the Commission does not need to make an adjustment to
2 account for the known and measurable increase in property tax expense because the
3 ADOR formula is sufficiently forward-looking. RUCO Br. at 14. According to RUCO,
4 the ADOR formula accounts for future increases in revenue by doubling the three-year
5 average of revenues. *Id.* RUCO never explains how doubling the three-year historical
6 average of operating revenues “inherently projects an increase in the operating
7 revenues.” Clearly, this is simply the means by which ADOR computes full cash value.
8 Two years from now (or five years from now), ADOR will still double the three-year
9 historical average. As long as revenues increase, property tax expenses will also
10 increase.

11 Finally, RUCO repeats the argument it made in the Rio Rico Utilities case that
12 the Commission’s methodology fails to consider the lag between approval of new rates
13 and the increase in property taxes. *Compare* RUCO Br. at 14 *with* Decision No. 67279
14 at 8. The Commission considered that argument and rejected it. *Id.* The ratemaking
15 process is full of time lags, most of which benefit ratepayers. For example, if the
16 Company constructs new plant, it must wait until the completion of a general rate case
17 before that plant is included in rate base and the Company begins to recover
18 depreciation and earn a return on its investment. RUCO is not concerned about those
19 sorts of time lags, only property taxes. The Commission should continue to reject
20 RUCO’s one-sided and backward-looking approach.

21 **C. RUCO’s Adjustment to Purchased Power Expense Is Understated.**

22 As discussed in the Company’s brief, Staff and RUCO agree that an adjustment
23 to purchased power expense is appropriate to account for increases in the rates charged
24 by Arizona Public Service Company (“APS”). Company Br. at 24. RUCO however,
25 recommends a lower adjustment. *Compare* Hubbard Rj. at 8-9 *with* RUCO Br. at 13.
26 Although RUCO boldly asserts that the Commission should adopt its lower adjustment

1 (RUCO Br. at 13, ls. 14-15), RUCO never explains why its adjustment is lower than the
2 adjustment recommended by the Company and adopted by Staff. Nor does RUCO
3 present any evidence to challenge the Company's calculation of the impact on
4 purchased power expense that results from the recent increase in APS's rates. RUCO's
5 recommended adjustment to purchased power expense is not supported by substantial
6 evidence and should not be adopted.

7 **D. Staff's Recommended Adjustment to Rate Case Expense Is Not Based**
8 **on Any Evidence or Actual Analysis.**

9 Staff claims that "Arizona Water's proposed rate case expense is excessive
10 compared to comparable cases, and is therefore imprudent." Staff Br. at 12. However,
11 the only "comparable case" ever discussed by Staff is the Eastern Group decision, and
12 the only evidence Staff presents is that the Western Group is smaller than the Eastern
13 Group. *Id.* See also Ludders Dt. at 11; Ludders Sb. at 6. The Eastern Group and
14 Western Group cases are generally comparable, but Staff's analysis stops there. While
15 the two cases shared the same process and many of the same issues, this case also
16 involved far more substantial participation by the City of Casa Grande, and unique
17 issues such as recovery of CAP-related costs, which made this case more complicated
18 and more expensive.

19 Staff ignores the specifics of the instant case entirely, even though rate case
20 expense is the single most case-specific expense. Company Br. at 25. As a result, Staff
21 never explains how the difference in size between the two groups automatically leads to
22 lower rate case expense. In contrast, the Company's requested rate case expense
23 amount takes into consideration the actual circumstances present in this case and the
24 Company's actual costs to date. Therefore, the Company's request should be adopted.
25
26

1 **IV. PURCHASED POWER AND WATER ADJUSTMENT MECHANISMS.**

2 **A. It Is the Policy of the State and This Commission to Approve**
3 **Appropriate Adjusters.**

4 In this case, Arizona Water seeks authority to *retain* the PPAM and PWAM
5 approved by this Commission in prior decisions. The Company does not claim that it is
6 “entitled” to approval of the adjuster mechanisms pursuant to A.R.S. § 40-370, as Staff
7 erroneously asserts in its brief. Staff Br. at 4. Rather, the Company directs the
8 Commission’s attention to A.R.S. § 40-370 because its adoption reflects the
9 Legislature’s support for appropriate adjustment mechanisms and surcharges for
10 Arizona water utilities as a matter of state-wide policy. Moreover, the Commission
11 itself has expressed its support for the policy reflected in the statute. *See In the Matter*
12 *of the Arizona Corporation Commission’s Own Motion to Establish the Commission*
13 *Water Task Force*, Decision No. 62993 (Nov. 3, 2000) at 6.

14 In Decision No. 62993, the Commission specifically approved the use of
15 automatic adjustment mechanisms, based on the Commission’s Water Task Force.
16 Decision No. 62993 at 1 (Exhibit A-39). One of the issues addressed by the
17 Commission was the agency’s policy regarding A.R.S. § 40-370, which specifically
18 references the costs of purchasing water and power. In discussing this statute, the
19 Commission indicated that it had recently approved adjustment mechanisms for Arizona
20 Water, allowing Arizona Water to recover costs associated with the Monitoring
21 Assistance Program administered by the Arizona Department of Environmental Quality,
22 and for Rio Verde Utilities, allowing that utility to recover cost increases associated
23 with the purchase of CAP water. Decision No. 62993 at 6. The Commission stated that
24 these decisions “indicate that the Commission’s policy on A.R.S. § 40-370 applications
25 is to support appropriate pass-throughs, which should mitigate the industries [*sic*]
26

1 concerns.”¹¹ *Id.*

2 On several other occasions, the Commission has recognized that adjustment
3 mechanisms are appropriate for Arizona utilities. It did so when it approved the
4 purchased water and power adjustment mechanisms at issue in this case. *Arizona Water*
5 *Co.*, Decision No. 58120 (Dec. 23, 1992) at 30. It did so again when it authorized
6 continued use of the Company’s PPAM in the Northern Group case, where the
7 purchased power adjustment mechanism was not challenged. Decision No. 64282; Tr.
8 at 1245.¹²

9 Most recently, the Commission approved a power supply adjustment mechanism
10 for APS, which is the Company’s primary electric supply provider in the Western
11 Group. Decision No. 67744 (April 7, 2005).¹³ The adjustment mechanism was
12 approved to mitigate the effects on APS’s earnings and financial integrity from the
13 increased volatility of fuel and purchased power costs. *Id.* at 15. The Commission’s
14 decision creates a mechanism that allows APS to pass on increases (or decreases) in
15 power and fuel costs in a timely fashion, subject to Commission approval, thus reducing
16 reliance on expensive and time-consuming rate cases and reducing the impact of
17 regulatory lag on earnings and financial integrity.

18 In contrast, Staff and RUCO point to *one* decision – the Commission’s decision
19 for the Company’s Eastern Group – as controlling precedent. Staff Br. at 2; RUCO Br.

20
21 ¹¹ In light of the Commission’s position concerning A.R.S. § 40-370 as clearly
22 expressed in Decision No. 62993, Staff’s assertion that the statute is “unconstitutional
23 and void” seems disingenuous. Staff Br. at 4. At best, this reflects Staff’s belief. The
Commission has never addressed the statute. In any event, since the Company is not
asserting that the statute mandates that the Commission retain the PPAM and PWAM
for the Western Group, Staff’s position is immaterial.

24 ¹² None of the Northern Group systems purchase water and, as a result, they do not have
25 a PWAM.

26 ¹³ Docket No. E-0345A-03-0437.

1 at 15. At best, given the Commission's recent decision reauthorizing the same PPAM
2 for the Company's Northern Group systems in Decision No. 64282, the Company's
3 request for treatment different than the Eastern Group makes sense given the split
4 between the two most recent Company rate cases. Meanwhile, the selective reliance on
5 precedent by Staff and RUCO should not go unnoticed. RUCO, for example, ignores
6 the Eastern Group decision with respect to working capital, revenue annualization,
7 property taxes and rate design. Staff disregards the Eastern Group decision as it applies
8 to the dispute in this case over working capital and Staff's "nondiscretionary use" rate
9 design. Staff also ignores the testimony of its own accounting witness that the *only*
10 policy the Commission has is to "explore every issue case by case." Tr. at 1249.

11 In sum, in this case, the Commission should evaluate the propriety of continuing
12 the PWAM and PPAM in the Western Group based on all relevant factors, including the
13 adjustment mechanism recently approved for APS. The decision for the Eastern Group
14 appears to be an outlier.

15 **B. The PPAM and PWAM Are "Appropriate" Adjuster Mechanisms.**

16 **1. All Applicable Requirements Are Present.**

17 An automatic adjustment mechanism must initially be approved in the context of
18 a general rate case, in which the fair value of the utility's plant is found and used in
19 setting rates. *Residential Utility Consumer Office v. Ariz. Corp. Comm'n*, 199 Ariz.
20 588, 591, 20 P.3d 1169, 1172 (App. 2001) ("RUCO"); *Scates v. Ariz. Corp. Comm'n*,
21 118 Ariz. 531, 526, 578 P.2d 612, 617 (App. 1978). This is a general rate case in which
22 rates are established on the basis of a fair value determination. Therefore, Arizona
23 Water has complied with the requirements identified in *Scates* and *RUCO*.

24 Staff and RUCO argue that the Company's adjusters should not be approved
25 because Arizona Water has not met the "volatility" requirement. Staff Br. at 2; RUCO
26 Br. at 16. Neither party points to any Arizona authority for the proposition that a

1 particular expense must be “volatile” to qualify for recovery under an adjustment
2 mechanism. A.R.S. § 40-370, which the Commission has endorsed, contains no such
3 requirement. Nor does either party address the Company’s argument that, with respect
4 to the PPAM, the Company’s purchased power expense is at least as volatile as APS’s
5 costs of producing that power, which volatility led the Commission to approve a
6 purchased power and fuel adjuster for APS earlier this year in Decision No. 67744. Tr.
7 at 1048. Incredibly, however, RUCO claims that future power costs will be relatively
8 stable. RUCO Br. at 16. In fact, Staff and RUCO’s arguments focus entirely on historic
9 rates for power and water, while ignoring recent changes in the power markets. Staff
10 Br. at 2-3; RUCO Br. at 15-16.

11 It is common knowledge that electric rates have been increasing. The
12 Commission can certainly take notice of the fact that Salt River Project (“SRP”) has
13 increased its rates five times since 2000, and has announced a sixth increase that will go
14 into effect later this year. The Commission can also take notice of APS’s recent filing
15 of an Application for Surcharge (“Application”). Docket No. E-01345A-05-0526. In
16 its Application, APS, which just received a rate increase earlier this year, asserts that it
17 has already accumulated \$100 million of unrecovered fuel and purchased power costs.
18 Application at 1. APS points to recent increases in the cost of natural gas, which have
19 risen 22%, and purchased power, which have increased 58%, over the levels utilized in
20 Decision No. 67744. *Id.* at 2. APS estimates recovery of these cost increases through
21 its adjuster mechanism will result in additional increases of over 2%. These
22 circumstances are hardly the “stable” environment portrayed by Staff and RUCO in
23 their closing briefs, and support retaining the Company’s PPAM.

24 **2. Fairness Supports Approval of the PPAM and PWAM.**

25 The PPAM and PWAM benefit both the Company and ratepayers because they
26 allow Arizona Water to pass on known and measurable increases *and decreases* in the

1 costs of purchased power and water. In this light, it is difficult to understand the
2 opposition of the other parties. Unfortunately, the inescapable conclusion appears to be
3 that after a long period of decreasing rates where ratepayers benefited from the
4 Company's adjusters, the other parties now see the handwriting on the wall and wish to
5 eliminate them because power costs are increasing rapidly.

6 Staff does attempt to argue that the adjuster mechanisms create a disincentive for
7 the Company to seek lower costs for purchased power and water. Staff Br. at 3. As an
8 example, Staff points to Arizona Water's failure to find lower cost electricity in
9 Arizona's "competitive" marketplace for electricity. *Id.* at 3-4. However, neither Staff
10 nor any other party has presented any evidence that alternative sources of water or
11 power are available to the Company. In fact, on cross-examination, Mr. Olea could not
12 even state whether there were any electric service providers with valid CC&Ns that
13 could serve Arizona Water. Tr. at 1086-1091. Mr. Olea was even unsure whether the
14 Commission's rules governing competitive power suppliers remained in effect. *Id.*
15 *Compare Phelps Dodge Corp. v. Ariz. Electric Power Coop.*, 207 Ariz. 95, 83 P.3d 573
16 (App. 2004) (review denied) (setting aside substantial portions of the Commission's
17 rules governing electric competition and vacating all CC&Ns issued to competitive
18 electric service providers).

19 Furthermore, Arizona Water retains an incentive to reduce purchased power and
20 water costs with the PPAM and PWAM in place. Notably, the adjuster is only triggered
21 by changes in the *rates* for water and power, not the volume of use. Tr. at 1049. The
22 Company and its customers still have the ability to reduce the costs of power and water
23 through conservation efforts. Unlike the rates charged for water and power, the
24 Company and ratepayers have some measure of control over demand, and therefore
25 have an incentive to reduce usage.

26 Finally, Staff asserts that the PPAM and PWAM should not be approved to

1 protect the Company's financial integrity. Staff Br. at 2. In support of this amazing
2 proposition, Staff cites a text dealing with adjustment mechanisms in the electric
3 industry. *Id.* This is inconsistent with Arizona law, however, which recognizes that
4 adjustment mechanisms are intended to protect a utility's opportunity to earn its
5 authorized rate of return:

6 [Automatic adjustment clauses] allow a utility to increase or
7 decrease rates automatically "in relation to fluctuations in
8 certain, narrowly defined operating expenses." . . .
9 Automatic adjustment clauses are designed to ensure that
10 utilities maintain a relatively constant profit despite an
11 increase in a specific cost anticipated by the adjustment
12 clause. An automatic increase allows a utility to recoup cost
13 increases by passing the cost on to the customer, while at the
14 same time maintaining the utility's net income. . . . The
15 same is true in the converse situation, that of an automatic
16 decrease. The decrease in cost is passed on to the customer
17 without disturbing a utility's profit. In essence, an
18 automatic adjustment clause is designed to offset cost
19 increases or decreases, leaving the utility's ultimate net
20 income unchanged.

21 *RUCO*, 199 Ariz. at 591-92, 20 P.3d at 1172-73 (citations omitted), *quoting Scates*, 118
22 Ariz. at 535, 578 P.2d at 616. Thus, the PPAM and PWAM are fair to both the
23 Company and its customers, and their continued use should be authorized.

24 **V. COST OF CAPITAL.**

25 **A. Reply to Staff.**

26 **1. The Methods and Inputs Chosen by Staff Are Conceptually Flawed and Depress the Cost of Equity.**

Staff claims its cost of equity analysis is "rigorous" and "theoretically sound,"
while labeling the approaches used by two government agencies, the Federal Energy
Regulatory Commission ("FERC") and the California Public Utility Commission
("PUC") staff, "alien" and "unproven" and personally attacking the Company's expert,
Dr. Thomas M. Zepp. Staff's sarcasm is intended to mask the fact that the inputs
chosen by Staff's witness, Mr. Ramirez, depress Staff's cost of equity estimates,

1 causing Staff's models to produce results that move in the opposite direction of the cost
2 of capital.

3 With respect to Staff's estimates using discounted cash flow ("DCF") constant
4 growth and multi-stage models, Staff has made the following inappropriate choices:

- 5 • Staff has used "spot" stock prices to compute the dividend yield in
6 both its constant growth and multi-stage DCF models. As a result
7 of the stock prices Staff selected, the dividend yield is 30 basis
8 points *less* than Staff's dividend yield in the Chaparral City Water
9 Company case.
- 10 • Staff has given 50% weight to historic growth rates, many of which
11 result in an indicated equity cost *below the cost of debt*. The FERC
12 relies on forward-looking estimates of growth, and eliminates from
13 consideration any individual utility equity cost estimate that is not
14 at least 40 basis points above the cost of investment grade bonds.
- 15 • Staff has relied on geometric averages instead of conceptually
16 correct arithmetic averages. The use of geometric averages lowers
17 the resulting equity cost estimates.
- 18 • Staff obtained forward-looking estimates of growth and considered
19 those growth rates (albeit giving them only 50% weight) in its
20 constant growth DCF model estimate, but chose to ignore them in
21 its multi-stage DCF model.

22 Zepp Rj. at 6-7 and 10-16; Company Br. at 37-43.

23 With respect to Staff's capital asset pricing model ("CAPM") estimates, Staff
24 again used inputs that are inappropriate and depress the resulting equity cost estimates:

- 25 • Staff has used one interest rate as its risk-free rate and another
26 interest rate to estimate the market risk premium, which creates an
improper mismatch and reduces Staff's CAPM equity cost estimate
by 40 to 60 basis points. Mr. Fox has admitted this error.
- Staff has ignored known empirical studies of the CAPM, which
show that the returns estimated for low beta stocks (like the water
utility sample group) are too low relative to required returns for
average risk stocks, and has used the average yield on intermediate-
term Treasury Securities as the risk-free rate. That choice is
theoretically unsound and reduces the equity cost estimate.
- Staff uses an extremely volatile method of estimating the current
market risk premium, resulting in CAPM equity cost estimates that
move in the *opposite* direction of interest rates and beta risk.

1 Zepp Rj. at 11-24; Company Br. at 44-48. As a result, Staff's CAPM estimate is the
2 same as its estimate in the Company's Eastern Group case, even though interest rates
3 and beta risk of Staff's sample water utilities have both increased significantly.

4 The result of these inputs is that Staff's recommended return on equity in this
5 case is only 9.1% – *less* than the return authorized by the Commission in the Eastern
6 Group case. Yet interest rates have increased (and continue to increase), and the
7 average beta of Staff's sample water utilities, which reflects those utilities' market or
8 systematic risk, has increased from 0.58 to 0.71. At the same time, the six water
9 utilities in Staff's sample group are currently earning, on average, 10.5% on equity, and
10 the three largest water utilities in the sample group are projected to earn 10.8% in 2006
11 and 12.0% in 2008 through 2010. Exhibits A-19 and A-20.

12 **2. Staff's Criticisms of the Company's DCF Model Equity Cost**
13 **Estimates Are Unfounded.**

14 **a. Staff Has Used "Spot" Prices to Lower the Dividend**
15 **Yield.**

16 Staff argues that Dr. Zepp's calculation of the dividend yield is inappropriate
17 because it was based on "analyst forecasts" and not on "spot" stock prices. Staff Br. at
18 13. This misrepresents Dr. Zepp's testimony. Dr. Zepp used the FERC's approach to
19 calculate the average dividend yield for the water utility sample group. The FERC uses
20 *actual* stock prices to calculate the stock's average dividend yield over a six-month
21 period to ensure that the dividend yield is not distorted by the price of the stock on a
22 particular day. Zepp Dt. at 30 and Table 4. RUCO similarly uses an average of actual
23 stock prices to compute the dividend yield. Rigsby Dt. at 21. Dr. Zepp did not use
24 projected or forecasted stock prices, as erroneously stated in Staff's brief.

25 The basic problem with "spot" prices, which Staff completely ignores in its
26 brief, is that they allow an analyst to manipulate the dividend yield. Tr. at 108 and 158-
59. If the analyst wishes to lower the dividend yield, he looks for a day on which the

1 stocks' prices are unusually high.¹⁴ Conversely, if the analyst wishes to increase the
2 dividend yield, he looks for a day on which stock prices are unusually low. Here,
3 Staff's "spot" prices produced a dividend yield 30 basis points *less* than the dividend
4 yield Staff has recommended in the Chaparral City Water Company case. Zepp Rj. at
5 6-7: Tr. at 108-09.¹⁵ This issue has nothing to do with the efficient market hypothesis,
6 but rather with ensuring that the equity cost estimate is fair and unbiased. That is why
7 the FERC properly uses an average, as opposed to selecting stock prices on a particular
8 day, and why Dr. Zepp adopted the FERC's approach in this case. *Id.*

9 **b. The FERC's Use of Forward-Looking Growth Rates Is**
10 **Appropriate.**

11 Staff also criticizes the FERC for relying on analysts' forecasts in its 1-step and
12 2-step DCF models. Staff Br. at 14. That criticism is misplaced for several reasons.

13 First, Staff has relied on analysts' forecasts in estimating dividend growth in
14 both of its DCF models. In its constant growth DCF model, Staff gives 50% weight to
15 forward-looking growth rates forecast by *Value Line* and 50% weight to historic (i.e.,
16 backward-looking) growth rates. *E.g.*, Ramirez Sb., Schedules AXR-3, AXR-4 and
17 AXR-6. Moreover, in its multi-stage DCF model, Staff relies *exclusively* on forecasted
18 dividend growth to determine its near-term growth. Ramirez Dt. at 25. Thus, Staff's
19 criticisms apply with equal force to Staff's own DCF estimates.

20 Second, there is substantial empirical evidence that financial analysts' forecasts
21

22 ¹⁴ The dividend yield component of the DCF formula is equal to the expected annual
23 dividend (D_1) divided by the price of the stock (P_0). Thus, the higher the stock price,
the lower the dividend yield and vice versa.

24 ¹⁵ In the Chaparral City case, Mr. Ramirez chose stock prices on April 20, 2005.
25 Surrebuttal Testimony of Alejandro Ramirez, Docket No. W-02113A-04-0616 (filed
26 May 5, 2005), at 3. In this case, he chose stock prices on May 11, 2005. Ramirez Sb. at
2.

1 of growth rates provide a sound basis for estimating equity returns:

2 Published studies in the academic literature demonstrate that
3 growth forecasts made by security analysts represent an
4 appropriate source of DCF growth rates, are reasonable
5 indicators of investor expectations and are more accurate
6 than forecasts based on historical growth. These studies
7 show that investors rely on analysts' forecasts to a greater
8 extent than on historic data only. . . .

6 Empirical studies have also been conducted showing that
7 investors who rely primarily on data obtained from several
8 large reputable investment research houses and security
9 dealers obtain better results than those who do not. Thus,
both empirical research and common sense indicate that
investors rely primarily on analysts' growth rate forecasts
rather than on historical growth rates alone.

10 Roger A. Morin, *Regulatory Finance: Utilities' Cost of Capital* 154-55 (1994).

11 Third, in any case, as Dr. Zepp pointed out (Zepp Rb. at 33), if investors rely on
12 forecasts of dividend and earnings growth – as David Dreman, the authority Staff relies
13 on, says they do – dividend yields would reflect such forecasts under the efficient
14 market hypothesis, and equity cost estimates based on such forecasts would likewise
15 reflect the cost of equity. In this case, Dr. Zepp used growth rate forecasts from four
16 widely followed analysts, *Zacks*, *Thompson First Call*, *Standard & Poor's* and *Value*
17 *Line*. Zepp Rj., Rejoinder Table 1. Staff (as well as RUCO) used forecasts from *Value*
18 *Line*. E.g., Ramirez Dt. at 16, 17, 18, 22 and 25 (discussing Staff's use of various *Value*
19 *Line* forecasts in its DCF model estimates).

20 Ultimately, the real issue is *not* the FERC's use of analysts' forecasts (given that
21 Staff and RUCO also rely on them), but Staff's use of historic data in its constant
22 growth DCF model and its exclusive reliance on forecasted DPS growth in its multi-
23 stage DCF model. While Staff suggests that the analysts' forecasts used by the parties
24 are "overly optimistic" (Staff Br. at 14), Staff's equity cost estimates using historic
25 growth rates indicate that Staff's sample water utilities (excluding Aqua America) have
26 an *equity cost of 6.4%*, i.e., equivalent to an investment grade bond. Company Br. at 40

1 and Exhibit 2. With respect to Staff's multi-stage DCF model, Staff has not provided a
2 credible basis for ignoring its own forward-looking EPS and intrinsic growth rates, and
3 instead relying solely on forecasted DPS growth. Company Br. at 41-42.

4 **c. Staff's Other Attacks on the FERC 1-Step and 2-Step**
5 **DCF Models Are Groundless.**

6 Staff accuses Dr. Zepp of "creat[ing] a middle growth stage in restating Staff's
7 multistage DCF." Staff Br. at 14, l. 25. This is correct (*see* Zepp Rb. at 20-21 and
8 Rebuttal Table 10), but irrelevant because Dr. Zepp does not rely on that restatement.
9 Dr. Zepp also used both the FERC 1-step and 2-step DCF models with Mr. Ramirez's
10 data, in addition to providing updated estimates using those models with more current
11 data, in his Rejoinder Testimony. *See* Zepp Rj. at Table 11 (summary of rejoinder cost
12 estimates). Those estimates indicate the cost of equity is approximately 10.5%, which
13 is consistent with the average equity return currently reported for Staff's sample group
14 of water utilities. *See* Exhibit A-20.

15 Staff also accuses Dr. Zepp of using arithmetic averages, rather than geometric
16 averages, to calculate forward-looking estimates of growth, thereby "overstating" the
17 growth rates. In reality, as explained in the Company's Closing Brief, Mr. Ramirez
18 incorrectly uses geometric averages, which depress the cost of equity estimates
19 produced by Staff's DCF models. Company Br. at 42-43; Zepp Rj. at 12-15. In
20 response to the "example" provided by Mr. Ramirez, Dr. Zepp provided two tables,
21 Rejoinder Tables 8 and 9, demonstrating that an arithmetic average is the correct
22 ingredient to use because it takes into account variability in growth. Dr. Zepp also
23 attached excerpts from two well-known texts explaining why an arithmetic average
24 should be used in estimating capital costs. *Id.*, Rejoinder Exhibits TMZ-1 and TMZ-2.
25 Dr. Morin also explains why arithmetic averages should be used. Morin, *supra*, at 298-
26 300. Staff, in contrast, has provided no support for Mr. Ramirez's position other than

1 the erroneous example in his testimony.

2 Staff also suggests that the Commission should ignore the methods used by the
3 FERC because the FERC has used the 1-step (constant growth) DCF model in electric
4 cases and the 2-step DCF model in natural gas cases. Staff Br. at 16. That argument is
5 a red herring. Dr. Zepp adopted the FERC's methods (although he believes they are
6 conservative and may understate the cost of equity) because they mirror the constant
7 growth and two-stage DCF models that Staff has been using in recent water utility rate
8 cases. Tr. at 100. Staff acknowledges that different versions of the DCF model can be
9 applied to the same industry. Staff Br. at 16, n. 1. Dr. Zepp explained that there is no
10 reason for the DCF model to be applied differently depending on the particular entity
11 being analyzed. Tr. at 124-25. In fact, none of the finance models being used to
12 estimate the cost of equity was developed to set rates in utility rate cases. *Id.* at 125.
13 Ibbotson Associates, for example, describes constant growth (one-stage), two-stage and
14 three-stage DCF models in its 2005 Yearbook. *SBBI Valuation Edition 2005 Yearbook*
15 at 62-66. The FERC notes that many investment analysts use three-stage DCF models.
16 Zepp Dt. at 35-36.

17 In short, regardless of whether the FERC believes that electric utilities and
18 natural gas utilities have different risk characteristics, as Staff correctly notes, those risk
19 characteristics would be reflected in the market data used to implement the DCF model.
20 Staff Br. at 16. Dr. Zepp has used market data for the same sample of publicly traded
21 water utilities that Staff has chosen to use. Zepp Dt. at 12. Consequently, Dr. Zepp has
22 not only selected DCF models that mirror Staff's models, but has used market data for
23 the same group of publicly traded utilities that Staff has used. The FERC's use of
24 different versions of the DCF model in different rate cases is irrelevant.

25 3. The Risk Premium Method Is Preferable to the CAPM.

26 Staff has ignored the theoretical and application problems associated with its

1 CAPM estimate, which are summarized on pages 43 through 48 of the Company's
2 Closing Brief. The inputs used by Staff to implement the CAPM clearly depress that
3 model's equity cost estimate, as shown by comparing Staff's CAPM estimates in the
4 Eastern Group case and Staff's CAPM estimate in this case. Company Br. at 46-47.
5 Instead, Staff essentially argues that its CAPM estimate should be adopted because one
6 of the developers of the CAPM, Dr. William Sharpe, was awarded a Nobel Prize. Staff
7 Br. at 13. This argument is simplistic and self-serving, ignoring the fact that Staff's
8 CAPM estimates violate the CAPM's fundamental tenets because they move in the
9 opposite direction of both interest rates and beta risk.

10 Staff also argues that intermediate-term (i.e., 5-, 7-, and 10-year) Treasury
11 securities should be used as the proxy for the "risk-free" asset in implementing the
12 CAPM. Staff Br. at 15. Staff's arguments, however, are theoretically flawed and
13 unsupported by the record.

14 First, Staff argues that "the CAPM is a holding period model, and the holding
15 period of most investors is intermediate." *Id.*, ls. 4-5. In support of that argument, Staff
16 cites Mr. Ramirez's Surrebuttal Testimony at page 11. There, Mr. Ramirez states the
17 CAPM is a holding period model, citing only a footnote on page 27 of his own Direct
18 Testimony. That footnote refers to a page from a text on investments in which the
19 authors *assume* "that most investors consider the intermediate timeframe (5-10 years) a
20 more appropriate investment horizon." Frank K. Reilly and Keith C. Brown, *Investment*
21 *Analysis and Portfolio Management* (2003) at 439. Messrs. Reilly and Brown do *not*
22 state that intermediate-term Treasuries should be used in the CAPM, which would be
23 contrary to generally-accepted finance theory. *E.g.*, Ibbotson Associates, *SBBI*
24 *Valuation Edition 2005 Yearbook* at 57 ("If an investor plans to hold stock in a
25 company for only five years, the yield on a five-year Treasury note would not be
26 appropriate since the company will continue to exist beyond those five years.").

1 Under Staff's argument, moreover, the CAPM would produce multiple equity
2 cost estimates for the *same* company, depending on the particular investor's holding
3 period. For example, an investor who typically holds a stock for several months would
4 use the yield on a 90-day Treasury bill, while another investor planning to hold a stock
5 for one year would use the yield on a one-year Treasury note, while a third investor
6 would select a longer-term Treasury security to correspond to her individual planning
7 horizon. In its brief, Staff appears to recognize that this is an absurd result by citing a
8 statement that appears on page 11 of Mr. Ramirez's Surrebuttal Testimony to the effect
9 that under the "Capital Market Theory," all investors are assumed to have the same time
10 horizon, as opposed to having multiple time horizons.¹⁶

11 Second, Staff argues that long-term Treasuries contain a liquidity risk premium
12 that must be "subtracted out" if they are to be used as the risk-free rate in the CAPM.
13 Staff Br. at 15. That argument is another red herring. The yield on a long-term
14 Treasury is used in the CAPM as the proxy for the risk-free rate because it produces a
15 reasonable result. *E.g.*, Ibbotson Associates, *SBBI Valuation Edition 2005 Yearbook* at
16 57. In fact, Dr. Sharpe, who was awarded the Nobel Prize, has recognized that the
17 return on the "zero beta" asset (i.e., the risk-free rate) is significantly higher than the
18 average returns on Treasury securities. William F. Sharpe, *Investments* 401 (1985). *See*
19 *also* Zepp Rj. at 21.

20 Ultimately, this is simply another example of why the CAPM, although
21 theoretically interesting, has limited practical application. Because of these application

22 ¹⁶ Actually, the CAPM is not based on the "Capital Market Theory" as Staff states in its
23 brief, but instead on the model of portfolio choice developed by Harry Markowitz, who
24 was also awarded the Nobel Prize. *E.g.*, Eugene F. Fama and Kenneth R. French, "The
25 *Capital Asset Pricing Model: Theory and Evidence*," 18 *Journal of Economic*
26 *Perspectives* 26-28 (Summer 2004) (describing development of the CAPM); Richard A.
Brealey and Stuart C. Myers, *Principles of Corporate Finance* 187-97 (7th ed. 2003)
(same).

1 problems, the Risk Premium method is more widely used than the CAPM in setting
2 utility rates. Zepp Dt. at 39; Tr. at 123. The primary difference between CAPM and the
3 Risk Premium approach is that the Risk Premium method *directly* estimates the risk
4 premium for the sample group of companies, while under the CAPM, the risk premium
5 is measured indirectly and requires more assumptions to be made, leading to a higher
6 likelihood of error. Zepp Dt. at 5 and 34; Tr. at 227-29. For example, under the Risk
7 Premium method, there is no need to estimate a company's beta or to select an
8 appropriate proxy for the hypothetical "zero beta" asset.

9 Staff argues that the Risk Premium method used by the California PUC (adopted
10 by Dr. Zepp) is flawed because it uses "comparisons to actual or authorized returns on
11 equity," i.e., readily verifiable information. Staff Br. at 16. However, the California
12 PUC uses *realized* equity returns, not authorized returns. *E.g.*, Zepp Rj. at 6-7 and
13 Rejoinder Table 6 (updated Risk Premium estimates). Staff also argues that realized
14 equity returns should not be considered because those returns are "accounting" returns
15 and are therefore "different" than the cost of equity. Staff Br. at 16-17. That argument,
16 of course, ignores United States Supreme Court precedent. *E.g.*, *Fed. Power Comm'n v.*
17 *Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944) ("the return to the equity owner
18 should be commensurate with returns on investments in enterprises having
19 corresponding risks"); *Bluefield Water Works & Improvement Co. v. Public Service*
20 *Comm'n of West Va.*, 262 U.S. 679, 692-93 (1923). In its brief, Staff has not explained
21 who "discredited" those Supreme Court decisions, nor has Staff explained why an
22 investor would disregard actual earnings and, instead, rely solely on finance models.

23 **4. Arizona Water Has Presented Substantial Evidence That It**
24 **Faces Additional Risk and Therefore Requires a Higher Equity**
Return.

25 Arizona Water has also presented substantial evidence showing that it is more
26 risky than the six publicly traded water utilities in Staff's sample group. Company Br.

1 at 55-58. There is no evidence in the record that the “comparable” water utilities used
2 by Staff face risks of the nature of risks faced by Arizona Water.

3 In its brief, Staff ignores these risks and instead claims that the Commission has
4 rejected Dr. Zepp’s arguments in prior cases. Staff Br. at 14.¹⁷ First, this disregards the
5 specific evidence presented in this case, which includes not only evidence presented by
6 the testimony of Dr. Zepp but by other Company witnesses as well. *See, e.g.,* Garfield
7 Dt. at 6-12; Kennedy Rb. at 6-11. For example, in this case we have company-specific
8 evidence demonstrating that inverted block rate designs erode and destabilize revenues,
9 supported by authorities such as the American Water Works Association. *See* Company
10 Br. at 65-68. This point was not addressed in any prior decision, and must be
11 considered if an inverted-block rate design is adopted. *See, e.g.,* American Water
12 Works Association, *Principles of Water Rates, Fees, and Charges* 100 (5th ed. 2000)
13 (hereinafter “AWWA Manual MF”).

14 Second, as Staff’s primary witness, Mr. Carlson, explained, the Commission “has
15 no policies except to explore every issue case by case.” Tr. at 1249. Mr. Carlson
16 further testified that the Commission’s rejection of a party’s position in one case does
17 not necessary constitute a precedent, and may well be decided differently in the next
18 case. Tr. at 1250. Indeed, Staff is asserting positions in this case that have previously
19 been rejected by the Commission. For example, Staff’s proposed “lifeline” commodity
20 rate was rejected by the Commission in the Eastern Group case and, more recently, in
21 the Rio Rico Utilities case. Decision No. 66849 at 25; Decision No. 67279 (Oct. 5,
22 2004) at 19. There is no reason to revisit those decisions either.

23 Staff also argues that Arizona Water’s risks should be ignored because the CAPM
24

25 ¹⁷ The City makes the same argument in opposing a risk premium. *See* City Br. at 25-
26 26.

1 “includes a risk variable.” Staff Br. at 14. However, that argument is groundless. The
2 CAPM cannot be applied to Arizona Water because Arizona Water has no estimated
3 beta (it is not publicly traded). Instead, Staff used betas estimated by *Value Line* for its
4 six sample water utilities. The issue is whether Arizona Water is riskier than the larger,
5 publicly traded utilities. The estimated betas used in Staff’s CAPM estimate tell us
6 nothing about Arizona Water’s risks.

7 **5. Staff’s Post-Hearing Leverage Adjustment Should Be Rejected.**

8 While Staff argues that the Commission should ignore the Company’s evidence
9 regarding its risks, Staff also suggests that an adjustment for leverage is appropriate.
10 Staff Br. at 15. That argument is remarkable in several respects. First, Staff apparently
11 maintains that a company’s cost of capital is based solely on its *financial risk*, which in
12 turn is based on the amount of debt in the company’s capital structure. In fact, a
13 company’s risk is based on a number of different factors that affect its business. *E.g.*,
14 Morin, *supra*, at 36-38. Moreover, the particular rate-setting system to which a utility is
15 subject also affects risk. *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 314-15 (1989).
16 Mr. Ramirez acknowledges that *both* business and financial risk affect the cost of
17 equity. Ramirez Dt. at 11. Thus, Staff’s argument that only financial risk matters is
18 simply wrong.

19 Second, Mr. Ramirez proposed an adjustment for leverage in his Direct
20 Testimony. Ramirez Dt. at 33. Dr. Zepp responded to Mr. Ramirez, and explained why
21 Mr. Ramirez’s proposed adjustment is inappropriate. Zepp Rb. at 26-30. Among other
22 things, Dr. Zepp explained that Arizona Water was unable to issue bonds at a cost as
23 low as the water utilities in Staff’s sample group, demonstrating that Arizona Water is
24 more risky than the water utilities sample and requires a risk premium to offset that
25 additional risk. *Id.* at 27-28. Dr. Zepp also pointed out that in the Eastern Group case,
26 Staff proposed a negative adjustment for leverage, and the Commission rejected that

1 adjustment. *Id.* at 30. As a consequence, Mr. Ramirez reversed his position, and did
2 not recommend an adjustment for leverage in his Surrebuttal Testimony. Ramirez Sb.
3 at 1-2.¹⁸ In fact, at the time of the hearing, none of the parties recommended an
4 adjustment based on leverage. Tr. at 126-27.

5 For the foregoing reasons, Staff's suggestion that a negative adjustment for
6 leverage may now be appropriate should not be considered. If Staff (or any other party)
7 believes that an adjustment for leverage is appropriate in this case (and for the reasons
8 discussed above, it is not), that recommendation should have been disclosed prior to the
9 hearing.

10 **B. Reply to RUCO.**

11 RUCO recommends an equity return of 9.44% based on the result of Mr.
12 Rigsby's DCF analysis. Rigsby Dt. at 6. As discussed in the Company's Closing Brief,
13 Mr. Rigsby has used the constant growth DCF model to estimate the cost of equity for a
14 sample group of publicly traded water utilities, American States Water, Aqua America
15 and California Water Service. *Id.* at 17. Mr. Rigsby selected those three utilities
16 because he believes they face "the same types of risk that Arizona Water faces" (*id.*),
17 and *Value Line* provides "forward-looking information" (i.e. long-term estimates on
18 return on common equity and share growth) for those utilities (*id.* at 18). *See also* Tr. at
19 155-56. This forward-looking information is necessary because Mr. Rigsby has used
20 the sustainable growth method to estimate dividend growth. Rigsby Dt. at 14-15; Tr. at
21 161-62. Unfortunately, as explained by Dr. Zepp and as discussed in the Company's
22

23 ¹⁸ Mr. Ramirez's surrebuttal workpapers contained several schedules indicating he
24 evaluated whether an adjustment for leverage would be appropriate. He correctly
25 examined the *market value* of the sample utilities equity, which ranged from 77.3% of
26 total capital for Aqua America to 66.0% for American States Water, and averaged
71.2%. By comparison, Arizona Water's equity is 73.4% of total capital. *See also* Zepp
Rj. at 28; Tr. at 88-89.

1 Closing Brief, Mr. Rigsby failed to use the information reported in his schedules, and
2 substituted his own subjective views in estimating dividend growth, resulting in an
3 unreasonably low equity cost estimate. *E.g.*, Company Br. at 51-54.

4 RUCO presents four arguments to support its recommended 9.44% cost of
5 common equity, none of which has any merit. First, RUCO claims that its
6 recommendation is reasonable “given the current environment of low inflation and low
7 interest rates.” RUCO Br. at 17. Although interest rates are at relatively low levels,
8 they have increased since mid-2003, as graphically depicted on Chart 1, found on page
9 8 of Mr. Ramirez’s Direct Testimony. The average of intermediate-term Treasuries was
10 only 3.3% at the time Staff prepared its CAPM model estimates in the Arizona Water
11 Company Eastern Group case. As of May 11, 2005, the average of intermediate-term
12 Treasuries was 4.0%. Moreover, interest rates are projected to increase in 2006. Zepp
13 Rj., Rejoinder Table 5 (forecasts of Treasury rates for 2006). In contrast, RUCO’s DCF
14 model estimate in this case is only 27 basis points greater than RUCO’s DCF model
15 estimate in the Eastern Group case. *See* Decision No. 66849 at 21.

16 Second, RUCO also suggests that a downward adjustment could have been made
17 to its DCF model estimate based on leverage. RUCO Br. at 17. However, like Staff,
18 RUCO did not propose an adjustment for leverage, as acknowledged in RUCO’s brief.
19 Dr. Zepp has explained why such an adjustment would be inappropriate for Arizona
20 Water. Zepp Rb. at 26-30. Mr. Rigsby responded by simply noting that Arizona Water
21 was ultimately able to place its Series K bonds, ignoring the fact their cost was 37 basis
22 points higher than an A-rated bond and 49 basis points higher than an AA-rated bond.
23 Rigsby Sb. at 30-31; Zepp Rb. at 27.¹⁹ As Dr. Zepp explained, the real issue is the cost

24
25 ¹⁹ Aqua America has an AA- bond rating, while American States and California Water
26 Service have A bond ratings. Exhibit A-20.

1 of Arizona Water's bonds, which indicates Arizona Water requires a risk premium of at
2 least 37 to 49 basis points above the cost of equity for the sample water utilities. Zepp
3 Rj. at 28-29.

4 Third, RUCO claims that the growth rates estimated by Mr. Rigsby, based on his
5 own subjective views, exceed the estimates of independent securities analysts by 50 to
6 61 basis points. RUCO Br. at 17. However, the projected EPS growth rates shown on
7 Schedule WAR-6 (including *Zacks'* projection for California Water) average 8.8%, as
8 compared to Mr. Rigsby's sustainable growth rate of 6.5%. Dr. Zepp presented more
9 current forecasts of future earnings growth in his Rejoinder Testimony, which included
10 forecasts from *Zacks*, *Thompson First Call*, *Standard & Poor's* and *Value Line*. The
11 average for American States Water, Aqua America and California Water Service is
12 7.6%, again substantially higher than Mr. Rigsby's sustainable growth rate estimate
13 using subjective inputs. Zepp Rj. at 29 and Rejoinder Table 1. Combining the current
14 analysts' forecasts of EPS growth with Mr. Rigsby's average dividend yield results in
15 an equity cost of 10.54% (7.6% + 2.94%), which is consistent with the updated results
16 of the FERC DCF models and California PUC Risk Premium method. Zepp Rj. at 29
17 and Rejoinder Table 11.

18 Finally, RUCO acknowledges that Mr. Rigsby's recommendation is based on an
19 unorthodox version of the DCF model, which assumes that "the book and market value
20 of a utility's stock will be driven toward equality" by regulation. RUCO Br. at 17-18.
21 RUCO's formula is not consistent with the constant growth DCF model developed by
22 Dr. Gordon, as described in Mr. Rigsby's testimony. Rigsby Dt. at 7-8. It is also
23 inconsistent with the constant growth DCF models used by Staff and the FERC, as well
24 as recognized authorities on the cost of capital. *E.g.*, Ibbotson Associates, *supra*, at 62-
25 63 (describing the single-stage or Gordon growth model); Morin, *supra*, at 157-61
26 (discussing the sustainable growth method of estimating future growth and earnings and

1 dividends). Putting aside the lack of authority for RUCO's unorthodox model, there is
2 simply no evidence that the stock prices of the three water utilities in RUCO's sample
3 group will move toward book value. *See, e.g.*, Exhibit A-23; Exhibit R-3; Zepp Rj. at
4 30 and Rejoinder Exhibit TMZ-3; Tr. at 114-119. Ultimately, this is simply another
5 example of RUCO's witness substituting his personal view for market data.

6 **C. Reply to the City.**

7 The City has not presented any equity cost estimates or recommended a specific
8 return on equity, but instead argues that the Company's risks are reduced by three
9 factors: (1) the amount of debt in its capital structure (i.e., leverage), (2) a "dramatic
10 product sales growth rate," and (3) "a diversified collection of water systems." City Br.
11 at 23. None of these arguments has any merit.

12 The impact of leverage has previously been discussed. It is important to note,
13 however, that the City apparently did not understand Dr. Zepp's testimony during the
14 hearing. The City has incorrectly focused on the book value of equity and debt as
15 opposed to the market value of equity and debt for both the sample water utilities and
16 the Company. As Dr. Zepp explained, in response to questioning by the City's counsel:

17 But the capital structure that you're asking about has
18 nothing to do with what is on the books. The difficulty is
19 that if you're going to ask about financial risk, you need to
be talking about the market value of equity and the market
value of debt.

20 Tr. at 88. In short, Dr. Zepp agreed that a higher equity ratio reduces risk, but the
21 evaluation needs to consider market values rather than book values. Tr. at 89; Zepp Rj.
22 at 28.²⁰

23 To support its second argument, the City has misstated Dr. Zepp's testimony. In

24 ²⁰ As noted above, Mr. Ramirez apparently considered a leverage adjustment in
25 preparing his Surrebuttal Testimony, based on his workpapers, but determined such an
26 adjustment would not be appropriate.

1 response to questions by the City's counsel, Dr. Zepp explained that while customer
2 growth would likely lead to increased water sales and increased revenues, customer
3 growth would also lead to an increase in costs, which may increase more rapidly than
4 revenues. Tr. at 90-91. Such costs would include additional capital investment in new
5 utility plant, on which the Company will not be allowed to earn a return until the plant
6 has been placed in service *and* recognized in rate base following the completion of a
7 general rate case.

8 [I]f a utility has an impending large construction program,
9 rate relief requirements and regulatory treatment uncertainty
10 will increase regulatory risks as well, lowering credit
11 quality. Regulatory risks stemming from a substantial
construction program include approval risks, lags and
delays, potential rate base exclusions, and potential
disallowances.

12 Morin, *supra*, at 44. Operating expenses would also increase and, depending on the
13 extent and nature of those increases, may increase more rapidly than revenues. It is
14 naïve to assume, as the City does, that growth automatically reduces risk.

15 Moreover, the City's argument is one-sided because it implicitly assumes that
16 Arizona Water will experience more growth than the sample utilities. The City's
17 witness, Mr. Harvey, provided no evidence to support that assumption. In fact, the
18 revenues of the three largest utilities have increased rapidly and are projected to
19 continue to increase:

	<u>Annual Revenues (\$ Million)</u>		
	<u>1995</u>	<u>2004</u>	<u>2008-10</u>
American States	\$129.8	\$228.0	\$320.0
Aqua America	117.0	442.0	650.0
California Water	165.1	315.0	500.0

25 Exhibit A-19. The issue is whether Arizona Water is more risky than the publicly
26 traded water utilities in the sample group. If those utilities are also expected to

1 experience “dramatic product sales growth” (City Br. at 23), it is inappropriate to
2 assume, as the City does, that Arizona Water is less risky.

3 Finally, the City argues that “the more highly diversified a utility, generally the
4 less risky” [*sic*]. City Br. at 24. Because Arizona Water operates 22 different water
5 systems, the City claims it is “highly diversified” and therefore has less risk than the
6 sample water utilities. In support of this argument, the City again misstates Dr. Zepp’s
7 testimony. Dr. Zepp explained that to benefit from diversification, the utility would
8 have systems in different states, resulting in different weather affecting customer
9 demand and different regulatory treatment by different state agencies. Tr. at 93 and
10 119-20. Dr. Zepp stated that an example of a diversified water utility would be Aqua
11 America. Tr. at 120. Aqua America is the holding company for water and wastewater
12 utilities that serve approximately 2.5 million people in 14 different states. Exhibit A-19.
13 Aqua America’s current annual operating revenues exceed \$450 million, it has a bond
14 rating of AA-, and its current return on common equity is 11.7%. Exhibit A-20. Aqua
15 America is projected to earn 12.5% on common equity in 2006, and 13% during the
16 2008-2010 period. Exhibit A-19. Presumably, the City agrees that Arizona Water,
17 which is much smaller than Aqua America and operates in a single state, should have a
18 higher equity return than Aqua America.

19 In addition, the City has ignored Mr. Garfield’s testimony on this issue. Mr.
20 Garfield explained why Arizona Water faces greater business risk by operating a
21 number of small systems. Garfield Dt. at 9-11. Among other things, Mr. Garfield
22 explained that many of the Company’s water systems are small and geographically
23 isolated. *Id.* at 10. As a result, Arizona Water is required to invest additional capital in
24 utility plant and incur additional operating expenses to ensure that each individual
25 system is properly operated and maintained. *Id.* In addition, the Company must have
26 personnel that are multi-disciplined assigned to each individual system, making it more

1 difficult to achieve operational economies of scale. *Id.* at 10-11. Mr. Garfield's
2 testimony is not disputed, and undermines the City's argument.

3 **VI. RATE DESIGN.**

4 **A. Reply to Staff.**

5 The arguments presented by Staff in support of its rate design conflict with the
6 evidence in the record and prior Commission decisions. The Staff begins by claiming
7 that its rate design "is the only rate design in this case that is consistent with the
8 Commission's decisions in recent cases." Staff Br. at 1. This is simply not true. In
9 fact, Staff's rate design conflicts with the Commission's decisions on rate design in the
10 Company's Eastern Group case and the Rio Rico Utilities case. Decision No. 66849 at
11 25; Decision No. 67279 at 19. As explained in the Company's Closing Brief, Staff's
12 rate design is predicated on providing a discounted commodity rate for the first 3,000
13 gallons of "nondiscretionary" water use each month. Moreover, Staff has also proposed
14 significant commodity rate discounts for use in the next commodity tier. *See* Company
15 Br. at 63 (table showing Staff's proposed discounts). In the case of Casa Grande, for
16 example, Staff proposes a 36% discount below the existing commodity rate for all usage
17 in the first block, and a 26% discount below the existing commodity rate for all usage in
18 the second commodity block. *See* Ludders Sb., Schedule REL-16. At the same time,
19 Staff is proposing a revenue increase of approximately 1%. *Id.*, Schedule REL-1. Thus,
20 while there would be very little change in the overall revenue requirement, Staff
21 proposes dramatic changes in the revenue allocated to each meter size.

22 This rate design is even more extreme than the rate designs the Commission
23 rejected in the Eastern Group and Rio Rico Utilities cases. In the Eastern Group case,
24 Staff proposed a discount of 20% for usage in the initial block. Decision No. 66849 at
25 25. In the Rio Rico Utilities case, Staff proposed a 16% discount in the commodity rate
26 for the initial block. Staff's proposed rate design in the Rio Rico Utilities case and

Staff's proposed rate design in this case are as follows:

	<u>Rio Rico Utilities</u>		<u>AWC Casa Grande</u>	
Existing Rate	\$1.27	—	\$1.56	—
Proposed 1 st Tier (Nondiscretionary Use)	\$1.07	-16%	\$1.00	-36%
Proposed 2 nd Tier	\$1.61	+27%	\$1.15	-26%
Proposed 3 rd Tier	\$1.93	+52%	\$2.00	+28%

Decision No. 67279 at 18 - 20.²¹ The Commission rejected Staff's rate design in the Rio Rico Utilities case because it "is lower than the current commodity cost and appears to have the result of shifting a greater proportion of the rate increase to the larger meter sizes." *Id.* at 19. Staff's proposed rate design in this case will result in far more extreme shifts in revenue responsibility. This approach is unfair to customers on larger-size meters, and should again be rejected.

Staff also claims its rate design "is the only design that takes seriously the State's important goal of encouraging conservation." Staff Br. at 1. That statement is also incorrect. Pricing water at a cost that is substantially below the existing commodity rate can hardly be described as a conservation-oriented rate structure. In Casa Grande, for example, the average number of customers during the test year was 14,221. Exhibit A-17, Schedule H-2 at 1. Of those customers, 13,276, or 93%, were served by 5/8 x 3/4-inch meters. Those customers would be eligible for Staff's discounted rate for their initial 3,000 gallons of "nondiscretionary" use, and would also receive an additional 26% discount below the existing commodity rate for all usage between 3,001 and 10,000 gallons per month. Ludders Sb., Schedule REL-16 (Casa Grande). Average

²¹ As in this case, Staff's discounted rate for "nondiscretionary use" would have applied only to customers on 5/8 x 3/4-inch meters, and not to customers on larger sized meters. Decision No. 67279 at 18.

1 monthly usage by Casa Grande customers served by 5/8 x 3/4-inch meters is 10,701
2 gallons. Exhibit A-17, Schedule H-2 at 1. Given the large discounts provided under
3 Staff's rate design, a customer will be required to use substantially in excess of the
4 monthly average before he or she will see any rate increase.

5 As shown by Exhibit A-39, the customers in Casa Grande that will be most
6 impacted by Staff's rate design are the customers on larger-sized meters. As explained
7 in the Company's Closing Brief, numerous studies have shown that those customers are
8 more responsive to price changes, and are most likely to adjust their usage, resulting in
9 under-collection of revenues. Company Br. at 65-67. Although Staff contends that its
10 rate design will encourage water conservation, it vigorously objects to any consideration
11 of price elasticity, claiming that the various studies that are summarized in Exhibit S-21
12 are "old, coming before 1994." Staff Br. at 5. That argument is misplaced for several
13 reasons.

14 First, the Beecher report was published by the National Regulatory Research
15 Institute in 1994 and, therefore, the numerous studies cited in Table 3-4 are prior to that
16 date. Exhibit S-21 at 97-101. However, that certainly does not invalidate the studies on
17 which the authors rely. Indeed, applying Staff's reasoning, the Commission should
18 reject the CAPM simply because it was developed in the mid-1960s. See Brealey and
19 Meyers, *supra*, at 195. Indeed, subsequent empirical studies have raised serious
20 questions regarding the use of the CAPM. Company Br. at 48. In contrast, there are no
21 studies invalidating the conclusions reached in the Beecher report. Staff has offered no
22 recent studies or any other evidence suggesting water demand is no longer price elastic.
23 Moreover, the current edition of the American Water Works Association's Manual M1
24 (published in 2000) devotes a chapter to price elasticity and its importance in designing
25 rates. AWWA, *Manual M1* at 157-60. See also Company Br. at 66.

26 Staff also contends that the Company's own evidence of price elasticity should

1 be ignored. Staff Br. at 5. Staff claims that Mr. Kennedy did not take weather into
2 account and did not consider the effect of growth on water usage. *Id.* Staff ignores the
3 fact that water consumption in the Eastern Group decreased during the April 2004
4 through March 2005 time period, following the imposition of inverted block rates in the
5 Eastern Group case, while consumption increased during the same time period for the
6 10 systems in the Company's Northern and Western Group systems, which have a
7 uniform commodity rate. Thus, for example, while a new home in Apache Junction (an
8 Eastern Group system) may have desert landscaping and more water-efficient
9 appliances, new homes in Casa Grande (Western Group) and Sedona (Northern Group)
10 would also be likely to have desert landscaping and more water-efficient appliances.
11 Once again, while Staff criticizes the Company's study, Staff offers no evidence that
12 refutes it.

13 Finally, Staff contends that the Company's position is internally inconsistent
14 because it has not recommended an adjustment for price elasticity based on reduced
15 usage resulting from a higher revenue requirement without regard to changes in rate
16 design. Staff Br. at 5-6. On this point, Staff has misstated Mr. Kennedy's testimony:

17 Q. [By Mr. Sabo] And did you propose an elasticity
18 adjustment to account for the effect of [the Company's]
increased rates on usage?

19 A. No. Because we have had experience with that rate
20 design since before my time with the company in 1987. We
21 know what is going to happen. We don't have to do a price
22 elasticity study when there is no change in the rate design.
When there is a major change in the rate design, that's when
you need a price elasticity [study] more so than when you
are maintaining an existing rate design.

23 Tr. at 702-03. Mr. Kennedy also explained that under a uniform block rate, "you do not
24 incur the same volatility that you do under a tiered rate," and that the radical change
25 proposed by Staff (using Casa Grande as an example) will dramatically increase the
26 effects of price elasticity. Tr. at 703. Mr. Kennedy's testimony is consistent with

1 authorities such as the American Water Works Association, which states:

2 Increasing block rate structures tend to result in more
3 revenue volatility than other rate structures (i.e., decreasing
4 and uniform block rates). This revenue volatility is because
5 an increase block rate anticipates recovering a
6 proportionally greater percentage of the customer class's
7 revenue requirement at higher levels of consumption. These
8 higher levels of consumption tend to be more subject to
9 variations in seasonal weather and, when coupled with a
10 higher unit pricing, customers tend to curtail consumption in
11 the higher consumption blocks.

12 AWWA, *Manual M1* at 100.

13 In reality, Staff – not Arizona Water – is the party taking inconsistent positions
14 on the issue of rate design. Staff contends that its rate design is “conservation based”
15 (Staff Br. at 6), while contending at the same time that its rate design will have no
16 impact on customer water use. In fact, the witness sponsoring Staff's rate design
17 testified that he is not aware of inverted-block rates ever resulting in reductions in water
18 use. Tr. at 1311. He also testified that the Commission has no policies, and decides all
19 issues on a case-by-case basis. Tr. at 1249, 1304 and 1304-05. Under these
20 circumstances, there is simply no basis to adopt a radical change in rate design, which is
21 unsupported by a cost of service study or any analysis of the impact on customers'
22 monthly bills, and would destabilize the Company's revenues and prevent the Company
23 from actually earning its authorized rate of return.

24 **B. Reply to RUCO.**

25 As explained in the Company's Closing Brief, RUCO's rate design is even more
26 seriously flawed than Staff's rate design because it applies the same blocking factors to
all meter sizes. Company Br. at 69-70. Like Staff, RUCO's rate design would create a
discounted, “lifeline” rate applicable to the first 4,000 gallons of consumption, but
because RUCO proposes to use the *same* breakover point for all customers, regardless
of meter size, RUCO's rate design would have an even greater impact on customers

1 served by larger-sized meters. *Id.* at 70 (table showing percentage of use in RUCO's
2 upper rate block). And like Staff, RUCO has failed to perform a cost of service study or
3 similar analysis, and ignored the impact of its rate design on water consumption and the
4 Company's revenues. Kennedy Rb. at 25; Company Br., Brief Exhibit 5.

5 RUCO's justification for its rate design is that it does not "discriminate" between
6 customers because "each customer pays the same commodity rate for the same level of
7 usage." RUCO Br. at 17. That contention is erroneous. First, customers on larger-
8 sized meters are already paying a substantially larger monthly minimum charge. For
9 example, RUCO has proposed a monthly minimum charge of \$10.40 for customers on
10 5/8 to 3/4-inch meters and a monthly minimum charge of \$363.93 for customers on 6-
11 inch meters – a multiple of 35. Rigsby Dt., Schedule WAR-17 (Casa Grande). Second,
12 as shown in the Company's Closing Brief, virtually all of the usage by customers on
13 larger-sized meters would fall into RUCO's upper rate block, even if those customers
14 conserve water.

15 Ultimately, like Staff's rate design, RUCO's rate design is simply a way of
16 shifting revenue recovery to customers on larger-sized meters, and has been rejected in
17 the past by the Commission. *Rio Rico Utilities*, Decision No. 67279 at 18-19
18 (concluding RUCO's rate design "does not create an equitable sharing of the rate
19 increase"). This rate design should be rejected once again.

20 **C. Reply to the City.**

21 The City has not proposed a rate design, and instead "supports the Commission's
22 prior decisions ordering the use of a multi-tier rate design." City Br. at 28-29.
23 Presumably, this means that the City agrees with Arizona Water that the rate designs
24 proposed by Staff and RUCO, which are predicated on creating a "non-discretionary"
25 use or "lifeline" rate, should again be rejected. The City, however, also argues that
26 Arizona Water has refused to follow the Commission's prior rulings. City Br. at 28.

1 While the City was not a party to the Rio Rico Utilities case, it was a party to the
2 Company's Eastern Group case, and therefore should be aware that the Commission
3 rejected Staff's proposed "lifeline" rate design in that case.

4 The City also criticizes Arizona Water for failing to provide an updated cost of
5 service study. Again, however, the City should certainly be aware, based on its
6 participation in prior Company rate cases, that the Commission has not required a new
7 cost of service study where no change in the rate design is proposed. Kennedy Dt. at
8 24. In reality, the City should be criticizing Staff and RUCO, both of whom are
9 proposing new rate designs that would cause dramatic shifts in revenue responsibility
10 without a cost of service study or similar analysis, without performing a billing analysis
11 evaluating the impacts of their rate designs on customers, and without analyzing
12 possible consumption and revenue impacts. Kennedy Rb. at 25; Company Br., Brief
13 Exhibits 4 and 5.

14 Finally, the City argues that Arizona Water has not presented "any reliable
15 evidence" showing that it is likely to lose revenue if an inverted-block rate design is
16 imposed. City Br. at 28. In fact, Arizona Water has presented substantial evidence,
17 summarized on pages 65 through 68 of its Closing Brief, that inverted-block rates create
18 revenue instability and will likely lead to under-collection of revenues. On this
19 particular issue, Mr. Harvey, the City's consultant, supports Arizona Water: "There is
20 ample information regarding price elasticity for the Company to predict any reduction in
21 water usage and associated revenue." Harvey Dt. at 9. Indeed, the Company's study
22 evaluating changes in water consumption between its Eastern Group systems, which
23 currently have an inverted-block rate structure, and the Company's remaining systems,
24 which have uniform commodity rates, provides a valid basis to forecast the likely
25 reduction in water use and associated revenues, as Mr. Harvey has testified.

26 In short, like Staff and RUCO, the City has adopted an ostrich-like approach, and

1 simply refuses to acknowledge that an inverted-block rate design will actually influence
2 customers' water use patterns, despite its own witness' testimony, and negatively
3 impact large industrial and commercial enterprises within the City. If that is the case, it
4 is difficult to understand why the City is supporting an inverted-block rate design in this
5 case.

6 **VII. MISCELLANEOUS ISSUES.**

7 **A. The City's Criticism of Arizona Water's Efforts to Finance Arsenic**
8 **Treatment Facilities is Unwarranted and Unsupported.**

9 The City supports implementation of an arsenic cost recovery mechanism
10 ("ACRM") for Casa Grande, Stanfield and White Tank, modeled after ACRMs
11 previously approved for the Northern and Eastern Group systems. City Br. at 29 (the
12 City "generally agrees" with Staff and the Company on arsenic cost recovery).
13 Nevertheless, the City continues to criticize Arizona Water's efforts to obtain "low
14 cost" financing for arsenic treatment facilities, and suggests that it could play some
15 vague and ambiguous role as a financing broker. *Id.* See also Harvey Dt. at 4-5;
16 Harvey Sb. at 5. However, the City's criticism is untimely, as well as vague and
17 speculative.

18 The deadline for complying with the new standard for arsenic is January 23,
19 2006 – three months after a final decision in this matter is anticipated. Whitehead Dt. at
20 7. For this reason, the Company's efforts to finance and construct facilities for all of its
21 water systems that require arsenic treatment began sometime ago. Tr. at 556-60;
22 Decision 66400 (October 14, 2003) at 16-17. Throughout this process, the Company's
23 overarching goal has been to obtain the necessary treatment facilities at the lowest cost
24 to ratepayers. Tr. at 559. In fact, this issue was addressed by the Commission in the
25 second phase of the Company's Northern Group rate proceeding, in which the City
26 participated. Decision 64400 at 16-17.

1 In the second phase of the Northern Group proceeding, the Commission directed
2 Arizona Water to conduct additional research to investigate the availability of grants
3 and/or loans to finance the construction of arsenic treatment facilities. *Id.* The
4 Company undertook this effort, and presented additional evidence to the Commission,
5 on the basis of which the Commission concluded that Arizona Water had made
6 "reasonable efforts" to obtain the lowest cost financing available. *Id.*²² Although the
7 City intervened in the second phase of the Northern Group proceeding, it made no effort
8 to challenge the Commission's findings or to present evidence that alternative, low-cost
9 sources of financing were actually available. The City did not offer to "partner" with
10 Arizona Water in the Northern Group case, nor did the City do so in the Eastern Group
11 case. In fact, in those cases, the City said nothing about financing for arsenic treatment.

12 Moreover, in this case, the City has failed to present any competent evidence
13 regarding the availability of low-cost financing. Instead, the City has presented
14 speculation that such financing might be available from some unidentified source if the
15 Company would just "partner" with the City. Harvey Dt. at 5 ("City should have much
16 more involvement" in the Company's effort to treat arsenic on a "cost effective basis");
17 Harvey Sb. at 5 (the City "could take the lead role here and could attempt to secure
18 support for the project in a public-private partnership.") However, on cross-
19 examination, Mr. Harvey admitted that City had not "explored anything." Tr. at 926.

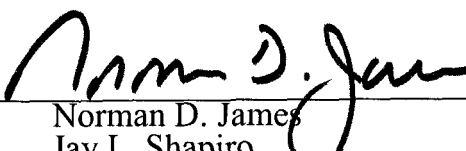
20 We are now five months from the compliance deadline. The City had the
21 opportunity to raise this issue in two prior rate cases, and failed to do so. Mr. Harvey's
22 testimony on this issue (like all of his testimony) is vague and amorphous at best.

23
24 ²² Among other things, the Company evaluated the availability of financing through the
25 Water Infrastructure Finance Authority of Arizona ("WIFA") and concluded that WIFA
26 financing for Arizona Water might not be the best use of WIFA's limited arsenic
treatment facilities financing pool. Decision 66400 at 16-17.

1 Ultimately, this is simply another example of the City criticizing Arizona Water without
2 any legitimate basis to do so.

3 RESPECTFULLY SUBMITTED this 22nd day of August, 2005.

4 FENNEMORE CRAIG

5
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13 ORIGINAL and 13 copies of the foregoing
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17 A copy of the foregoing was delivered this
18 ~~22nd~~ day of August, 2005, to:

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REPLY BRIEF

EXHIBIT 1

~~D.— The owner of an underground facility~~ underground facilities operator, in its sole discretion, may satisfy the requirements of ~~this subsection C of this section~~ by allowing an authorized person to inspect or copy installation records themselves.

Sec. 8. Section 40-360.32, Arizona Revised Statutes, is amended to read:

§ 40-360.32. One-call notification center membership; termination

~~A. Every public utility, municipal corporation, underground facility owner or person having the right to bury underground facilities~~ every underground facilities operator who is obligated to locate and mark underground facilities pursuant to section 40-360.22, subsection B, shall be a member of a one-call notification center, either statewide or serving each county in which such entity or person has underground facilities. Each one-call notification center shall establish a limited basis participation membership option, which may be made available to all members, but which must be made available for any member serving less than one thousand customers or any member irrigation or electrical district. ~~A facility owner~~ An underground facilities operator who elects limited basis participation membership ~~will~~ shall provide to the one-call notification center the location of its underground facilities solely by identifying the incorporated cities and towns, or for unincorporated county areas, by ~~indentifying~~ identifying the townships, in which it has facilities. The service level provided to limited basis participation members by the one-call notification center is limited to providing excavators with the names and telephone numbers the excavators should contact to obtain facilities location. Each one-call notification center shall establish fair and reasonable fees for limited basis participation members, based on customer count, areas occupied or miles of underground facilities. When any person neglects or refuses to pay fees when due and is in arrears for sixty days, the one-call notification center may terminate the membership of that person without notice and may have a claim for fees and a separate claim for damages for breach of an ancillary agreement. The one-call notification center may refuse to reinstate any person's membership until that person's fee is paid in full.

~~B. This section does not apply to an owner or occupant of real property where underground facilities are buried if the facilities are used solely to furnish services or commodities to that property and no part of the facilities is located in a public street, alley or right-of-way dedicated to public use.~~

Approved by the Governor, April 25, 2005.

Filed in the Office of the Secretary of State, April 25, 2005.

COMMUNITY WATER SYSTEMS

CHAPTER 223

H.B. 2277

AN ACT AMENDING TITLE 45, CHAPTER 1, ARIZONA REVISED STATUTES, BY ADDING ARTICLE 13; RELATING TO COMMUNITY WATER SYSTEMS.

Be it enacted by the Legislature of the State of Arizona:

Section 1. Title 45, chapter 1, Arizona Revised Statutes, is amended by adding article 13, to read:

ARTICLE 13. COMMUNITY WATER SYSTEM PLANNING
AND REPORTING REQUIREMENTS

§ 45-330. Definition

In this article, unless the context otherwise requires:

1. "Community water system" means a public water system that serves at least fifteen service connections used by year-round residents of the area served by the system or that regularly serves at least twenty-five year-round residents of the area served by the system. A person is a year-round resident of the area served by a system if the person's primary residence is served water by that system.

2. "Large community water system" means a community water system that serves water to more than one thousand eight hundred fifty persons.

3. "Public water system" means an entity that distributes or sells water and that qualifies as a public water system under section 49-352, subsection B.

4. "Small community water system" means a community water system that does not qualify as a large community water system.

§ 45-331. Water plan

A. Except as provided in subsections D and E of this section, by the dates specified in subsections B or C of this section, each community water system shall prepare and submit to the director a system water plan that includes the following components:

1. A water supply plan.
2. A drought preparedness plan.
3. A water conservation plan.

B. Except as provided in subsection C of this section, a large community water system shall submit its first system water plan to the director on or before January 1, 2007, and shall submit an updated plan within six months prior to January 1 of every fifth calendar year thereafter. A small community water system shall submit its first system water plan to the director on or before January 1, 2008, and shall submit an updated plan within six months prior to January 1 of every fifth calendar year thereafter. For a small community water system that submits its request to the director at least ninety days before the filing deadline, the director may extend the time for filing the first water system plan. If a community water system revises its system water plan after submitting the plan to the director, the community water system shall submit the revised plan to the director within sixty days from the date of revision.

C. If more than one community water system serves water to residents within a city or town, two or more of the community water systems serving water to residents within that city or town may coordinate their efforts in preparing the plans required by this section and may submit a joint plan that contains the information required in this section for that portion of the community supplied by the community water systems instead of submitting individual water system plans. Community water systems that submit a joint plan pursuant to this subsection shall submit the plan to the director by the date on which a small community water system is required to submit its system water plan under subsection B of this section. The director may extend the time for filing the first water system plan for a joint plan that includes a small community water system if the request is received ninety days before the filing deadline.

D. A community water system that has been designated as having an assured water supply pursuant to section 45-576 is exempt from the requirement to submit a water supply plan under this section.

E. A community water system regulated as a large municipal provider under chapter 2, article 9 of this title is exempt from the requirement to submit a water conservation plan under this section. The director shall exempt a community water system regulated as a small municipal provider under chapter 2, article 9 of this title from the requirement to submit a water conservation plan under this section if the community water system:

1. Petitions the director for an exemption prior to January 1, 2007.
2. Demonstrates, under reasonable growth projections, that it will be regulated as a large municipal provider under chapter 2, article 9 of this title prior to January 1, 2012.

F. A community water system that has previously submitted information required by this section to the director may make a written request to the director to be exempted from the requirement to submit the information in its system water plan. The director shall grant the exemption if the director determines that the information is already on file with the department.

G. The director shall review a system water plan, including a revised plan, submitted by a community water system pursuant to subsection B of this section and shall notify the community water system in writing as to whether the plan complies with this section. If the director determines that the plan does not comply with this section, the director shall give written notice of that determination to the community water system and give the community water system at least one hundred twenty days to make revisions or additions as are necessary to bring the plan into compliance. If the community water system does not bring the plan into compliance by the date specified in the notice, the director shall provide notice of the noncompliance to the governing bodies of the cities, towns and counties located within the service area of the community water system. If the director determines that the plan is in compliance with this section but that changes would improve the plan, the director shall give written notice of the changes to the community water system but the water system shall not be required to make the changes.

H. The water supply plan shall evaluate the water supply needs in the service area and propose a strategy to meet identified needs. The plan shall include:

1. A list and description of service area lands, sources of supply, including emergency sources, well registration numbers and water levels at the well sites, if known, and storage and treatment facilities. The list shall not include water levels at well sites that are sources of supply for hard rock mining or metallurgical processing or industrial uses related to hard rock mining or metallurgical processing.
2. A map and description of existing transmission and distribution facilities, unless previously provided pursuant to section 45-498. For a small community water system a map is not required.
3. A description of monthly system production data categorized by the system's sources of supply and, for systems that use meters to measure withdrawals and diversions, a summary of system average daily demands, maximum monthly demands and an estimate of peak day demands for the past five years.
4. A list, description and map of existing interconnections unless previously provided pursuant to section 45-498, and the quantities of water sold to or purchased from other water systems during the previous five years, unless previously provided pursuant to section 45-632. For a small community water system a map is not required.
5. An analysis of present and future water supply demands for the next five, ten and twenty years.

I. The drought preparedness plan shall be designed to meet the specific needs of the water system for which it applies and shall include:

1. The name, address and telephone number of the community water system and the names of the officers or other persons responsible for directing operations during a water shortage emergency.

2. Drought or emergency response stages providing for the implementation of measures in response to reduction in available water supply due to drought or infrastructure failure.

3. A plan of action that the community water system will take to respond to drought or water shortage conditions, including:

(a) Provisions to actively inform the public of the water supply shortage and a program for continued education and information regarding implementation of the drought preparedness plan.

(b) Development of emergency supplies, which may include identification of emergency or redundant facilities to withdraw, divert or transport substitute supplies of the same or other types of water.

(c) Specific water supply or water demand management measures for each stage of drought or water shortage conditions, subject to approval by the corporation commission if the community water system is a public service corporation. This requirement may be met by providing a curtailment tariff on file with the corporation commission.

J. The water conservation plan shall be designed to increase the efficiency of the water system, reduce waste and encourage consumer water conservation efforts. The water conservation plan shall be designed to meet the specific needs of the community water system and shall include both demand and supply management measures including the following:

1. Feasible measures that may be implemented to determine and control lost and unaccounted for water.

2. Consideration of water rate structures that encourage efficient use of water, as set by the community water system's governing body, subject to approval by the corporation commission if the community water system is a public service corporation.

3. A continuing conservation education program containing provisions to actively inform the public of drought conditions and information regarding conservation measures to reduce vulnerability from drought conditions, including:

(a) Curtailment of nonessential water uses.

(b) Affordable efficiency technologies for indoor and outdoor use.

(c) Rebate and retrofit programs for indoor and outdoor uses.

(d) Reuse and recycling programs.

K. The water conservation plan shall be implemented by the community water system within twelve months after receiving written notification from the director that the plan complies with this section. For a community water system that receives a notice pursuant to subsection G of this section that the water conservation plan does not comply with this section, the water conservation plan shall be implemented within twelve months after the expiration of the date by which the system is required to make revisions or additions to the plan to bring it into compliance, as specified in the notice given to the system under subsection G of this section.

L. The director shall prepare forms that small community water systems may complete and submit as their system water plan under this section. The director shall distribute the forms on a timely schedule and furnish them upon request. Failure to receive or obtain a form does not relieve any community water system from the requirement to file a system water plan by the date prescribed in subsections B or C of this section. The director of water resources shall coordinate

with the corporation commission and the director of environmental quality in establishing the form to facilitate the reporting of similar or identical information to the department of water resources and the corporation commission or to the department of water resources and the department of environmental quality.

M. The director shall prepare a guidance document to assist community water systems in preparing the water system plan. The director shall cooperate with cities and towns, private water companies and irrigation districts that are community water systems in developing the guidance document and the form described in subsection L of this section.

§ 45-332. Records and annual report of water use; penalty

A. Each community water system that is required to file an annual report under this section and that uses meters to measure water withdrawals and diversions shall maintain current, complete, true and correct records of its withdrawals, diversions and deliveries of water in the form as prescribed by the director. Each community water system that is required to file an annual report under this section and that does not use meters to measure water withdrawals and diversions shall maintain records of the estimated amount of its withdrawals, diversions and deliveries of water in the form as prescribed by the director.

B. An annual report shall be filed with the director by each community water system. A community water system is exempt from the reporting requirements in this section if it is required to file an annual report under section 45-632.

C. A community water system required to file an annual report under this section shall report the following information:

1. If water was pumped or diverted by the community water system during the year:

(a) The quantity of water pumped or diverted and the well registration numbers of any wells used to pump or divert the water. Community water systems that do not use meters to measure water pumped or diverted shall estimate the quantity of water pumped or diverted.

(b) The number of customers to whom the community water system delivered water during the year.

(c) An identification of the number of storage facilities and the storage capacity of each facility.

2. If water was received by the community water system from another person during the year:

(a) The name of the person from whom the water was obtained.

(b) If the water was pumped or diverted, the registration numbers of any wells used to pump or divert the water, if known.

(c) The quantity of water received during the year.

(d) The number of customers to whom the community water system delivered water during the year.

(e) An identification of the number of storage facilities and the storage capacity of each facility.

3. If effluent that is generated from a wastewater treatment facility was used or received by the community water system during the year, the estimated quantity of effluent generated from the wastewater treatment facility during the year, the estimated quantity of effluent used directly from the wastewater treatment facility during the year and the specific uses to which the effluent was applied during the year.

D. Community water systems required to file annual reports under this section shall maintain a current map clearly delineating its service area and distribution system.

E. The records and reports required to be kept and filed under this section shall be in the form as the director prescribes. The director shall prepare blank forms and distribute them on a timely schedule and furnish them upon request. Failure to receive or obtain the forms does not relieve any person from keeping the required records or making any required report. The director shall cooperate with cities and towns, private water companies and irrigation districts that are community water systems in establishing the form of the records and reports to be kept and filed by them. The director of water resources shall coordinate with the corporation commission and the director of environmental quality in establishing the form of the reports required to be filed by this section to facilitate the reporting of similar or identical information to the department of water resources and the corporation commission or to the department of water resources and the department of environmental quality.

F. If a community water system fails to timely file the report prescribed by this section, the director shall provide a written notice to the water system that requires compliance within sixty days of the date of the notice. If the water system does not comply within the sixty day period, the director shall provide notice of that noncompliance to the governing bodies of the cities, towns and counties located within the service area of the water system.

G. A violation of this article does not constitute a violation of chapter 2 of this title.

Approved by the Governor, April 25, 2005.

Filed in the Office of the Secretary of State, April 25, 2005.

GOVERNMENT LEASES

CHAPTER 224

H.B. 2282

AN ACT AMENDING SECTIONS 41-1958 AND 41-2752, ARIZONA REVISED STATUTES; RELATING TO GOVERNMENT LEASES.

Be it enacted by the Legislature of the State of Arizona:

Section 1. Section 41-1958, Arizona Revised Statutes, is amended to read:

§ 41-1958. Acquisition of lands and buildings; lease-purchase agreements; lease or sublease of lands or buildings

A. The director may acquire for and in the name of ~~the~~ this state by lease, lease-purchase agreement or otherwise lands or buildings for the purpose of providing office space for the department at such places as the director finds necessary and suitable.

B. An agreement made for the lease, lease-purchase or purchase of the premises mentioned in subsection A of this section is subject to the approval of the attorney general and the director of the department of administration.

C. An agreement made for the purchase of the premises mentioned in subsection A of this section is subject to the review of the joint committee on capital review.

REPLY BRIEF

EXHIBIT 2

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2
3 IN THE MATTER OF THE
4 APPLICATION OF ARIZONA WATER
5 COMPANY, AN ARIZONA
6 CORPORATION, FOR ADJUSTMENTS
 TO ITS RATES AND CHARGES FOR
 UTILITY SERVICE FURNISHED BY
 ITS WESTERN GROUP AND FOR
 CERTAIN RELATED APPROVALS.

Docket No. W-01445A-04-0650

**AFFIDAVIT OF
WILLIAM M. GARFIELD**

7 STATE OF ARIZONA)
8 County of Maricopa) ss.

9 William M. Garfield, being first duly sworn upon his oath, deposes and says:

10 1. I am a resident of Maricopa County, over 18 years of age, and make this
11 affidavit based on my own personal knowledge.

12 2. I am the President of Arizona Water Company ("Arizona Water" or
13 "Company"), and in such capacity, I am generally responsible for managing the
14 Company's day-to-day utility operations. My background, education and professional
15 experience are described in the testimony I previously provided in this matter.

16 3. I have reviewed the Post-Hearing Opening Brief of the City of Casa Grande
17 ("CG Br."). In that brief, at page 8, the City of Casa Grande (the "City") discusses a
18 newspaper article published in the *Casa Grande Dispatch* on July 21, 2005. The City's
19 brief refers to comments by the Director of the Pinal County AMA reported in the article
20 regarding certain temporary limitations imposed on water for construction uses.

21 4. The City's reference to the newspaper article and its erroneous description
22 of this temporary situation is apparently intended to discredit Arizona Water's long range
23 planning efforts by characterizing the current peak summer demands as "unanticipated
24 demand" in the Company's Casa Grande system. (CG Br. at 8.) Thus, the City asserts,
25 the Commission should order the Company to prepare a "water resource master plan."
26

1 However, a water resource master plan would have had no impact on the circumstances
2 that gave rise to the recent restrictions on construction water deliveries.

3 5. This past July, Arizona Water was providing temporary construction water
4 service to roughly 60 construction projects in the Casa Grande area. Construction water
5 users do not provide for supply, storage or distribution system infrastructure and are not
6 permanent customers. Instead, construction crews use water directly from meters
7 connected to fire hydrants that Arizona Water sets upon request. Absent unusual
8 circumstances, after the meter is set, Arizona Water's involvement is limited to meter
9 reading and billing.

10 6. Arizona Water operates its system so that temporary construction water
11 use does not unduly impact Arizona Water's ability to meet the water demands of its
12 permanent customers. Further, although fire hydrants can be used to deliver water to
13 construction users, the primary purpose of fire hydrants is to provide water for fire
14 service to Arizona Water's permanent customers. Consequently, Arizona Water monitors
15 usage levels to ensure that an adequate supply is available to serve permanent customers
16 and for health and safety requirements.

17 7. Arizona Water has always had ample capacity to meet demand for
18 construction water, in addition to meeting its other operating requirements. However, as
19 I stated, there were roughly 60 construction projects underway last month, some of which
20 individually used in excess of one million gallons per week. In addition, Arizona Water
21 lost the use of three wells that were temporarily out of service shortly before and/or
22 during the period in which the water restrictions were imposed. Finally, central Arizona
23 experienced several weeks of very high temperatures in July.

24 8. Based on these circumstances, Arizona Water determined that some limited
25 restrictions on construction water use were necessary to meet permanent customers' water
26

1 demands and reserve adequate supplies for public health and safety. Water service to
2 permanent customers was not affected. Moreover, although there were several fires in
3 the City area during this time period, Arizona Water fully satisfied the fire service needs
4 of the local fire authority.

5 9. During the period of temporary restrictions, Arizona Water offered
6 construction water users access to alternative, non-potable supplies that could be trucked
7 to construction locations. However, no construction water user elected to obtain water
8 from those alternative sources.

9 10. Arizona Water has already taken the additional steps to increase water
10 supplies and has been meeting all of the water demands of its construction water users.
11 The three wells temporarily out of service are now back in service and operating within
12 normal parameters, and additional system improvements have been completed that will
13 increase Arizona Water's ability to meet demands for construction water.

14 11. The City has been aware of the foregoing. Arizona Water representatives
15 met on August 5, 2005, with the City Manager and the City Council. Arizona Water
16 shared all available information concerning the temporary restrictions on construction
17 water use and the steps the Company has taken to minimize any further impact on
18 construction water users.

19 11. I disagree with the City's suggestion, based on the newspaper article, that
20 Arizona Water is not engaged in adequate long-range planning because construction
21 water use was temporarily limited. If the City's arguments were true, it would mean that
22 every water provider in the State that experiences temporary difficulties has failed to
23 properly anticipate and meet demand. For example, municipal providers like Flagstaff
24 and Payson have placed restrictions on water use this summer. This is simply a risk that
25 every water service provider operating in Arizona faces, especially in the summer.

26

12. In sum, the newspaper article is incomplete and does not support the City's argument. Arizona Water's temporary limitations on construction water use had nothing to do with long-range planning, but were the result of a temporary situation. Arizona Water acted quickly and minimized the impact on construction water users. Most importantly, due to Arizona Water's knowledge of its system and proper planning, at no time was water service to permanent customers impacted. A water resources master plan like the City wants would have had no impact on Arizona Water's ability to anticipate or respond to extraordinary events such as those that led to the temporary limitation on construction water use.

William M. Garfield
William M. Garfield

SUBSCRIBED AND SWORN TO before me, the undersigned Notary Public, this
18th day of August, 2005.

Jackie R. Craig
Notary Public

My Commission Expires:

January 19, 2009



REPLY BRIEF
EXHIBIT 3

1 **ULRICH & ANGER, P.C., 193600**
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6 **(602) 248-9465**

7 William H. Anger, No. 7333
8 Paul G. Ulrich, No. 1838

9 Attorneys for the City of
10 Casa Grande

11 **IN THE SUPERIOR COURT OF THE STATE OF ARIZONA**

12 **IN AND FOR THE COUNTY OF MARICOPA**

13
14 **ARIZONA WATER COMPANY,**

15 Plaintiff,

16 vs.
17

18 **ARIZONA DEPARTMENT OF WATER**
19 **RESOURCES; et al.,**

20 Defendants.
21

No. CV 90-01840
No. CV 99-08015

**MOTION FOR LEAVE TO FILE
AMICUS BRIEF**

(Assigned to the Honorable
Roger W. Kaufman)

22 The City of Casa Grande petitions this Court for leave to appear as Amicus Curiae
23 and asks the Court to consider the attached brief.

24 The City of Casa Grande is the second largest City in Pinal County with
25 approximately 23,000 people. Currently, Plaintiff Arizona Water Company ("Arizona
26 Water") is Casa Grande's private municipal water provider for most of the City.

27 As with its Apache Junction system, Arizona Water disputes the Arizona
28 Department of Water Resources' (the "Department") final Second Management Plan
29 Gallons Per Capita Per Day ("GPCD") requirement for its Casa Grande system. The
30

1 administrative proceedings over the Department's Final Second Management Plan GPCD
2 requirement for its Casa Grande system has been voluntarily stayed by the Department
3 and Arizona Water during the pendency of this administrative appeal regarding Arizona
4 Water's Apache Junction system.

5 The City will not be adding any new issues or factual disputes to these
6 proceedings. Instead, the City will be addressing only one issue that has been raised by
7 Arizona Water at page 2 of its Opening Brief. This issue which the City has a vital
8 interest in and which the attached brief addresses states as follows:
9

10 (1) Should the Director's Decisions be invalidated because an irreconcilable
11 conflict exists between the requirements imposed on private water companies under
12 the Second Management Plan and the requirements imposed on private water
13 companies by Article 15 of the Arizona Constitution and Title 40 of the Arizona
14 Revised Statutes?

15 Casa Grande petitions to appear as amicus curiae and to file the attached amicus
16 brief because it has a vital stake in the welfare of its citizens concerning its limited water
17 supplies. The City believes that the position taken by Arizona Water in these
18 proceedings is contrary to law, public policy and the public welfare of the citizens of
19 Casa Grande.

20 During the pendency of this appeal, Arizona Water is negotiating with a private
21 corporation to provide CAP water and/or groundwater to an electrical generation plant
22 that requires over 3 million gallons of water per day on an average annual basis. The
23 City has an interest in the enforcement of the GPCD requirement to avoid the limited
24 potable water supplies in the Casa Grande area from being used and taken in violation of
25 the necessary regulations by the Department under the Groundwater Management Act.
26 Unlike other municipal providers having CAP allocations, Arizona Water is not
27 providing any of its CAP water allocation to Casa Grande residents. Faced with a
28 seriously overdrafted aquifer, the City's future depends upon the policies of the
29 Groundwater Management Act and the regulations of the Department being followed by
30 Arizona Water.

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1 The City will not bring the above facts regarding Arizona Water's Casa Grande
2 water system into these proceeding and none of these facts are addressed in the attached
3 brief. Instead, these facts are mentioned here to show Casa Grande's strong interest in
4 the outcome of this administrative appeal and being allowed to appear as amicus in this
5 matter.

6 The decision here regarding whether the Department's GPCD regulations under the
7 Second Management Plan should be invalidated because they allegedly conflict with the
8 requirements imposed on private water companies by Article 15 of the Arizona
9 Constitution and Title 40 of the Arizona Revised Statutes will apply directly to Arizona
10 Water's Casa Grande system. The City respectfully requests this Court to allow the City
11 to address this important legal issue that will significantly impact Casa Grande citizens.

12 DATED this 3rd day of April, 2000.

13 Respectfully submitted,

14 ULRICH & ANGER, P.C.

15
16
17
18 By 
19 William H. Anger
20 Paul Ulrich

21 Attorneys for the City of Casa Grande
22
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30

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1 COPY of the foregoing hand-delivered
2 this 3rd day of April, 2000, to:

3 Honorable Roger W. Kaufman
4 Maricopa County Superior Court
5 101 West Jefferson, 5th Floor
6 Phoenix, AZ 85003

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28
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30
